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Hoover, Bush, and Great Depressions

Mark Thornton

ABSTRACT: Rothbard (1963) provides a compelling explanation of the Great Depression. He used the Austrian business cycle theory to show that the inflationary policies of the Federal Reserve caused a boom in the economy of the 1920s that led to a bust in 1930. He then employed the Austrian theory of interventionism to show that Hoover's policies were highly interventionist and caused the depression to be "great." The combination of theories can be used to explain the stagflation of the 1970s, Japan's lost decade of the 1990s, and the current economic crisis, which is now the longest contraction since the Great Depression. Like Hoover, George W. Bush had a reputation as an advocate of laissez faire policy. However, he presided over a massive expansion in the size of government and deployed highly interventionist policies to address the crisis.

KEYWORDS: business cycle theory, fiscal policy, great depression, crisis management

JEL CLASSIFICATION: E32, E63, E65, H12, N12

INTRODUCTION

The most basic rule of economic policy is to allow prices to adjust to market conditions. This maintains Say's Law and produces

Mark Thornton is Senior Fellow at the Ludwig von Mises Institute and may be contacted at mthornton@mises.com. An earlier version of this paper was presented at the 2009 SEA meetings.

what Bastiat called economic harmony. Furthermore, unhampered markets also minimize distortions and disruptions introduced by external forces. Most importantly, the unhampered price system minimizes the impact of the business cycle on the economy. This paper examines two historical episodes in which interventionist policies turned business cycle corrections into depressions.[1]

The first episode occurred in the Great Depression during the Hoover and Roosevelt administrations. The second episode is the current economic crisis, which began during the George W. Bush administration and has carried over into the Obama administration.[2] Hoover's interventionist policies focused on labor markets with the goal of keeping wages and employment high. Bush's interventionist policies focused on capital markets with the goal of keeping financial markets functioning. While both Hoover and Bush have reputations of supporting limited government, the facts suggest that both went to unprecedented lengths in employing interventionist policies to fight economic crises. In both cases they failed, while managing to set the stage for further increases in the size and scope of government intervention.

In addition to setting the historical record straight, it will be argued that it was the interventionist policies undertaken during these crises that turned recessions into depressions. These policies created the conditions necessary for a depression primarily because they had the effect of undermining the workings of important areas of the price system. This is the Rothbard (1963) thesis of how a contraction in the economy became the Great Depression. Essentially, Rothbard uses the Austrian theory of the business cycle to construct a boom, bust, and recovery cycle. He then employs the Austrian theory of interventionism to explain why the economy does not recover but instead becomes snared in an ongoing depression. This approach can be applied to the present crisis to provide a better understanding of current events.

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[1] There is no official definition of an economic depression, and the term depression now refers to a severe recession. It has been suggested that criteria such as a decline in GDP of at least 10 percent, an unemployment rate of 10 percent or higher, or a recession lasting two or more years be used to designate a depression.

[2] While not officially a "great" depression, the current economic crisis is recognized as the most significant economic crisis since the Great Depression.

HOOVER THE INTERVENTIONIST

Hoover claimed to be a believer in limited government and European-style liberalism, but his actions both before and after the stock market crash of 1929 suggest otherwise. Before becoming President, Hoover spent many years in government service as an advocate of interventionist policies. After becoming President, Hoover undertook unprecedented and wide-ranging action to address the stock market crash of 1929. His interventionist policies were sufficient to transform a typical recession into the Great Depression. His actions were "limited" only in the sense that he did not want all of his policies to become permanent features of government. Additionally, in Hoover's day the federal government lacked the full complement of institutions and powers that it would attain in the post New Deal period.

However, the myth of Hoover as a do-nothing conservative who allowed the crisis to bloom into a depression remains as strong as ever. In the September 2008 issue of the *American Economic Review*, Gauti Eggertsson's article "Great Expectations and the End of the Great Depression" explicitly links Hoover with an adherence to the gold standard, balanced budgets, and small government. Nobel laureate Paul Krugman, the influential economic columnist at the *New York Times*, also subscribes to the Hoover myth (Murphy 2010). However, even the basic facts belie this myth. For example, federal spending increased by almost 50 percent over the two years following the crash (during a period of significant price deflation). During that same period, the federal budget went from a small surplus to a deficit of approximately 4 percent of GDP. Meanwhile, the Federal Reserve reduced interest rates from 6 percent to 1.5 percent—the lowest level in U.S. history.

In order to get a proper perspective on Hoover, recall that he had previously served on the War Planning Board in World War I and later agreed to serve President Warren Harding as Secretary of Commerce only if he was promised to have "a free hand in all economic policy." It is also revealing that as a result of all his tireless and frantic work throughout the federal government he was subsequently dubbed the "Secretary of Commerce and the Undersecretary of Everything Else."[3]

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[3] According to the Herbert Hoover Presidential Library and Museum (10/14/2009) http://hoover.archives.gov/exhibits/Hooverstory/gallery04/gallery04.html.

Based on Hoover's term as President, Franklin Roosevelt called the Hoover administration "the most reckless and extravagant that I have been able to discover in the statistical record of any peacetime government anywhere, any time."[4] Hoover's biographer Harris Warren (1959, p. viii) claims that Hoover's interventionism was so significant that he should be given credit for being the true architect of the New Deal:

> No one, it seems to me, has done justice to the Hoover Administration…. The result is a distorted picture of what some historians are calling "the age of Roosevelt." Projected against the customary biased, prejudiced, and grossly unfair accounts of Hoover's presidency, the New Deal assumes an unnatural and unreal luster. Forgotten is the fact that what Hoover did was in a very real sense preparation for the next steps known collectively as the New Deal.

Until recently, most of the economics profession has suffered under the myth that Hoover was a dogmatic proponent of laissez-faire economics. Fortunately, recent work from within mainstream economics seems to be finally making some progress in overturning this myth and confirming the Rothbard thesis. Lee Ohanian (2009) has developed a theory of "labor market failure" to explain the Great Depression. However, the labor market "failed" because of Hoover. Specifically, the failure was caused by Hoover's industrial labor program and his famous White House conferences where Hoover advised employers not to cut wages and to instead use labor sharing schemes when employment needed to be reduced. Ohanian concludes that Hoover's policies caused the Great Depression and made it three times more severe than necessary. It also would have been of far shorter duration had the policies not been put in place.[5] Vedder and Gallaway (1993, p. 146) have also demonstrated in great detail the validity of Rothbard's Hoover

[4] As quoted in Folsom, 2009, p. 40.

[5] Ohanian is also part of the team, Cole and Ohanian (2004), who showed that Roosevelt's New Deal policies did not get the U.S. out of the Great Depression, but indeed were the primary reason for its persistence. Using a similar model of labor market failure, they showed that Roosevelt's policies increased real wage rates significantly above market clearing levels, thus reducing employment and output. Of course this point has been made numerous times before—by Couch and Shughart (1998) for example—but this was the first time it was made by mainstream economists in a major academic journal.

thesis. They portray Hoover as a proto-New Dealer whose high wage policy turned a correction into a depression.

> [I]n a very real sense Roosevelt merely continued and expanded upon the high-wage doctrine first articulated by Hoover. Far from being the bold new reformer saving the nation from the laissez-faire prescriptions of a reactionary president, Roosevelt was a chief executive who adroitly and charismatically expanded the legacy left by his progressive, if colorless, predecessor. He was aided and abetted in this by the emerging respectability of underconsumptionism (later called Keynesianism) in the intellectual community.

The first point regarding the Rothbard thesis is that it was Hoover's Secretary of the Treasury, Andrew Mellon (a holdover from previous Republican administrations) who was the advocate of do-nothing liquidationism. Mellon wanted to allow the same type of financial liquidation to take place that quickly cured the Depression of 1920–21. Hoover understood that Mellon's recommendations were the policies followed by previous Presidents, and he steadfastly opposed that approach. Hoover had advocated New Deal-style policies during the Depression of 1920–21, but the economy recovered quickly under President Harding's policy of laissez-faire liquidationism.[6]

Hoover believed that if he could stimulate the economy with government spending, protect jobs, and keep wages from falling he could prevent a big bust in the economy. Throughout his term in office, Hoover would do anything that was politically feasible in order to achieve his purpose. Surprisingly, even after more than three years of crushing economic consequences from his policies, Hoover felt fully justified in his actions.

> The past three years have been a time of unparalleled economic calamity. They have been years of greater suffering and hardship than any which have come to the American people since the aftermath of the Civil War.
>
> …Two courses were open. We might have done nothing. That would have been utter ruin. Instead, we met the situation with proposals to private business and the Congress of the most gigantic program of economic defense and counterattack ever evolved in the history of the Republic. We put it into action. (Hoover, 1934, vol. 2, pp. 247, 249)

[6] See Woods (2009) on the speedy recovery of this depression.

The stock market began its meltdown on October 24, 1929. When the crisis hit, Hoover wasted little time putting to work his "proposals to private business and the Congress of the most gigantic program of economic defense and counterattack ever evolved."

On November 19 he met with the presidents of the railroads where he extracted promises from the railroads to increase construction and spending. Two days later he received promises from leading industrialists to expand construction, maintain wage rates, and to shorten the work week if labor had to be cut. The same day, labor leaders agreed with Hoover's plans, while the next day leaders in the construction industry agreed to maintain wage rates. On November 27, representatives from the public utility industries agreed to expand construction and to maintain wage rates.

The federal government began intervening in farming around the beginning of the 20th century, and Hoover promoted such intervention while working in the Harding administration. As President he supported subsidies and marketing cartels for farmers. For example, two days after the stock market crash, his pet bureau, the Federal Farm Board, announced $150 million in low interest loans for wheat co-ops and $10 million to set up a centralized marketing board for grain co-ops. More money was added to these programs and more crops incorporated into this policy, but naturally these subsidies only encouraged more production and lower, not higher, prices. Eventually, agricultural prices crashed, and the government programs lost millions of dollars.

By 1929, Hoover had already been promoting New Deal-like policies for more than a decade. His theory was both to keep wages and prices high and also to stimulate the economy with public (and private) works in order to protect the economy from depression and deflation. He incorrectly thought that high wages caused prosperity rather than prosperity causing higher wage rates. This is like a doctor treating the symptoms of a disease but only making the disease worse. All during this same time frame, Hoover pushed for more public works spending at both the federal and state levels.

In 1930 Hoover signed the Smoot-Hawley Tariff and pushed through other measures in an attempt to improve the unemployment rate such as banning immigration, increasing deportations, and even issuing propaganda to discourage people from entering the work force. Some might argue that it is unfair to include Smoot-Hawley as a New Deal or progressive policy, but it is included here because, like other such policies, it was designed to "protect" labor and keep wages high. There was also additional public works money allocated to "stimulate" the economy in 1930.

Throughout the remainder of his term in office, Hoover acted vigorously to increase spending on public works projects and to keep wages and prices high. In fact, real wage rates at the end of his term were higher than when he began his term in 1929 (despite the fact that the unemployment rate increased to all time highs, [Vedder and Gallaway, 1993, p. 84]). He also acted to change bankruptcy laws in favor of debtors, to establish the Reconstruction Finance Corporation and the Home Loan Bank, and a variety of other progressive measures to foster government lending and to alleviate the deepening economic crisis. Hoover and the Federal Reserve favored inflationary policies, but only to the extent that they did not threaten the viability of the gold standard.

Rothbard (1963) has demonstrated that the widely held view of Hoover as a disciple of laissez faire is clearly nonsense. He showed that Hoover's efforts to protect labor and keep wages high was a recipe for economic disaster, and that ultimately his policies were responsible for turning the recession of 1929–30 into the Great Depression. Furthermore, Hoover was actually an innovator and advocate of New Deal-like policies. For a contemporaneous account of the Hoover depression, see Garret (1932) and Robbins (1934). For a modern and concise restatement of Rothbard's analysis, see Murphy (2009).

BUSH THE INTERVENTIONIST

President George W. Bush claims to be an advocate of limited government, although his model is Ronald Reagan rather than European liberalism. He served when two large economic bubbles burst. During the first bust in 2001, Bush initially resorted to Keynesian remedies that did not work, but tax cuts in 2003 did quicken the pace of recovery. The second bubble burst near the end of his second term, and he undertook dramatic and unprecedented actions to save the economy. If the Austrian theory of the business cycle and theory of interventionism is correct, then Bush may have set the stage for America's Second Great Depression.

In contrast to folklore, it has been established that Hoover was a longtime interventionist even before he became President. What about George W. Bush? Was he an advocate of laissez-faire who turned Keynesian when the economic crisis emerged?

When George W. Bush ran for President in 2000, neither of the major candidates appealed to me. Frankly, my greatest concern was that neither candidate was very smart, and that one would indeed be elected President. During the campaign I received an email from a group called "Economists for Bush." The email contained a letter which had been signed by a number of important, free market mainstream economists. The email asked for my endorsement of Bush and his policies relating to Social Security, income taxes, education, government spending, and international trade. The Bush economic platform basically called for modifications of how government should run everything with a simple promise of better, more efficient management.

Studying these political promises, I thought about the two possible ideologies of George Bush: the old Bush family ideology of inflation and war, and the younger Bush's adopted ideology of evangelical conservatism. I ultimately decided that both ideologies would lead to bad economics. His promises were simply not good enough. The "letter" came in the form of an email in which the email addresses had been placed in the "Cc:" line rather than the "Bcc:" line, so I decided to take the opportunity to offer a memo of my own to this group.

In my return memo I rejected the idea of endorsing the Bush economic plan. For example, the plan called for "strengthening" and "saving" Social Security. By any reasonable account, Social Security has become the unsustainable and dangerous institution that critics have maintained over the last three quarters of a century. I responded that any rational policy should have the aim of eliminating Social Security "as quickly as humanly possible." The budgetary plank of the letter called for holding down government spending, redirecting funds to the military and paying off the national debt. In response I noted that the mechanisms Bush called for to hold down spending would not work and that "we already spend enough on national defense unless you have in mind getting America involved in even more international conflicts like the former Yugoslavia, Iraq, Somalia, etc."

It hardly seems worth the effort to demonstrate that George W. Bush was not a small-government conservative during his terms in office. For example, annual federal spending increased by over $1.1 trillion during his tenure and an additional $1 trillion in 2009. Even as a percentage of GDP, federal spending increased from 18.5 percent in 2001 to 21 percent in 2008. This was the highest level since 1994, and it erased all the progress that had occurred during the Clinton years. Instead of holding down government spending, he greatly increased it in all areas.

Bush also famously took the federal budget from a massive surplus to a massive deficit. If we adjust the federal budget deficit/surplus for inflation and then compare that figure to GDP, we find that Bush came into office with a real budget surplus of 1.3 percent of GDP and left with a real deficit of 3.2 percent of GDP. There were hardly any budget surpluses in my lifetime until the Clinton tech bubble of the late 1990s. Bush's economic legacy is therefore a return of the large and growing budget deficits of his father's generation. Instead of "continuing to pay off the national debt," we now must shoulder trillion dollar annual deficits for the foreseeable future.

The Bush administration's response to the emerging crisis started with the usual interest rate cuts by the Federal Reserve. In mid-December of 2007, the Federal Reserve announced the first of many unprecedented moves with the Term Auction Facility (TAF) in which loans would be auctioned off to depository institutions based on a variety of collateral. They also established reciprocal currency arrangements with the European Central Bank and the Swiss National Bank. In mid-February of 2008, President Bush signed into law the Economic Stimulus Act of 2008, which provided $150 billion in tax rebates. In mid-March, the Federal Reserve announced the Term Securities Lending Facility, which could lend up to $200 billion of Treasury securities to institutions on collateral. They also announced the Primary Dealer Credit Facility and the Fed's arrangement of J.P. Morgan's subsidized takeover of Bear Stearns. The administration first tried to financially bolster Fannie Mae and Freddie Mac in July, but the two government-sponsored entities had to be bailed out and taken over in September. The takeover of AIG would quickly follow, along with the government's backing of money market accounts. In October, Bush signed into law the $700 billion Troubled Asset Relief Program, or TARP, and increased deposit insurance to $250,000. Finally, the U.S. Treasury Department purchased $125 billion in preferred stock in nine U.S. banks.

This is just a rough sketch of the Bush's effort to fight the crisis during the last year of his tenure. Most of the programs mentioned above experienced several extensions and expansions, and of course there were many other interventions such as the bailouts for American automakers and expansions of foreign credit lines and swaps. Much of the administration's response came from the Federal Reserve, which was in the hands of Bush appointee Ben Bernanke, and from the Treasury Department, which was also headed by a Bush appointee, the former CEO of Goldman Saks Hank Paulson. It would therefore seem clear that President Bush is a big-government interventionist and that his administration attacked the economic correction with an extensive and in many cases unprecedented interventionism. The only major difference from Hoover is that while Hoover mainly targeted wage rates and employment, Bush made the preservation of financial markets a high priority.

INTERVENTIONISM TURNS CRISIS INTO DEPRESSION

Austrian economists have a well-developed theory that explains the boom, bubble, bust, and recovery. A good introduction to the Austrian theory of the business cycle can be found in Larry Sechrest's article "Explaining Malinvestment and Overinvestment." Sechrest wrote the article to provide a pedagogical device for economic students, but academic economists will probably be able to understand it as well.

Here we examine the case of business cycles in which, instead of recovery, the economy enters a prolonged economic depression or recession. The types of intervention that cause business cycles are restricted to money and credit. The types of intervention that cause depressions can be of a monetary, fiscal or regulatory nature. Even moral suasion can contribute to the making of a depression, as was the case with Herbert Hoover. The most effective depressionproducing program would include a variety of interventions. The only necessary requirement is that the interventions help to forestall the correction process and that the interventions collectively undermine the ability of the price system and the system of profit and loss to properly reallocate resources. Austrians find that the cycle is the result of monetary intervention *and* that depressions emerge as the result of subsequent interventions designed to forestall the corrective processes of the bust.

Among all business cycles, few have degenerated into prolonged depressions or recessions. Most business cycles come and go so quickly that received wisdom recommends that the government do nothing except for minor adjustments to monetary and fiscal policy along with so-called "automatic stabilizers." The exceptions to this rule include the Great Depression, the stagflation of the 1970s, the Japanese "Lost Decade," and possibly the current economic crisis.

What makes the difference between the ordinary business cycle and an extraordinary depression? The one factor that is consistent in all four of the major crises is massive government intervention to address the initial economic crisis. In all four cases, the government responded, not in the traditional laissez faire manner of leaving things alone, but instead with policies that attempted to reverse the economic crisis.

In the first three major depressions, governments consistently intervened in the economy and made long-term institutional changes in the economy. In the case of the stagflation of the 1970s, the government met the initial crisis with comprehensive wage and price controls and the closing of the gold window, along with a loose monetary policy, deficit spending and bailouts. The Japanese bubble-bust was also met with intervention on a massive scale including bailouts, zero percent interest rates, public works spending and huge budget deficits. Even Paul Krugman was impressed with Japan's efforts:

> Think of it as the WPA on steroids. Over the past decade Japan has used enormous public works projects as a way to create jobs and pump money into the economy. The statistics are awesome. In 1996 Japan's public works spending, as a share of GDP, was more than four times that of the United States. Japan poured as much concrete as we did, though it has a little less than half our population and 4 percent of our land area. One Japanese worker in 10 was employed in the construction industry, far more than in other advanced countries. (Krugman, 2001)

Unfortunately it did not work, the stagnation continued, and all that deficit spending has left Japan with a staggering national debt.

The reason that interventionism does not work is that it misallocates more resources in the economy. More importantly, it disturbs, distorts and destroys the corrective process whereby entrepreneurs, the price system, and the bankruptcy and foreclosure procedures do their jobs in reallocating resources and prices back into a sustainable framework.

In dealing with economic crisis, one prominent weapon in the arsenal of interventionist economic policy is a loose money and credit policy. This policy has the defect of preventing, or at least stalling and distorting, the process of deflation, which provides the cleansing and rebalancing effect on the economy where resources can be reallocated to more valuable and sustainable uses. Loose monetary policy also sets up expectations for a more restrictive monetary policy in the future, while its low interest rates discourage savings and future growth. Loose monetary policy in the 1970s (US), 1990s (Japan), and today (globally) have produced no curative effect, and notice that most economists consider Paul Volcker's restrictive monetary policy in the early 1980s a success.

Public works spending, stimulus packages and deficit spending are also (wrongly) considered important policies to address economic contractions. The idea is that government spending replaces declining private sector spending in order to maintain the level of GDP. However, it is easy to recognize that such policies also stifle the reallocation of resources that is called for in any type of correction process. Government spending is determined politically and bureaucratically, so there will inevitably be mismatches in resources in the economy. As government spends, it creates relative scarcities in resources like cement and bulldozers, and relative abundances in resources like golf carts and electrical engineers. Such micro-misalignments create new roadblocks on the path to economic recovery. In the short run, such policies produce less than a dollar's worth of bang for the buck (even if it does increase GDP by a dollar). In the longer term, this approach increases the government debt and tax burdens on the economy. The evidence from the Great Depression, the stagflation of the 1970s, and the Japanese malaise clearly suggest that the government spending approach has more of a debilitating than a remedial effect. In the current crisis, the stimulus package of $787 billion has failed by a wide margin to meet projections of the Obama Administration of containing the unemployment rate at less than 8 percent.[7]

Bailouts are simply a hidden form of discretionary protectionism and should be the poster child for the ill effects of interventionism. Instead of allowing for entrepreneur-driven change (restructuring, downsizing, outsourcing, takeovers, mergers, etc.), bankruptcy and foreclosure, and other forms of adjustment to take place, bailouts forestall the adjustment process, engender rent seeking, and create a moral hazard. In the absence of bailouts, there are myriad ways in which individuals adjust to economic downturns that are largely "unseen" by politicians and bureaucrats, but which are nonetheless the basic elements of the corrective process. The presence of bailouts turns the attention of entrepreneurs away from such adjustments and towards the acquisition of bailouts and other rent seeking and non-productive activities. Bailouts also set a precedent and thereby create a moral hazard that destabilizes rather than stabilizes the economy. In the current crisis, we have seen everything from bailouts for banks that are "too big to fail," to the takeovers of AIG, GM, Fannie Mae and Freddie Mac, and forbearance laws and policies that prevent foreclosure on homeowners who are delinquent on their mortgages. Many of the same effects caused by protectionist trade policies also apply to bailouts.

There is yet another negative effect from interventionist policies that is important to consider. The combination of interventionist policies, quickly conceived, implemented, and often altered, fosters an environment of "regime uncertainty." Higgs (1997) described this concept as entrepreneurial uncertainty brought about by uncertainty regarding the future of economic policy, or simply policy that threatens entrepreneurs and investors. One might imagine the entrepreneur who is trying to digest several policy changes being told that there is a crisis and that policy X will save him, only to learn that policy X has failed and will be replaced by policy Y which will save the day, only to learn that policy Y has not worked, but that policy Z will get the job done. All of this confusion causes entrepreneurs to suffer from "regime uncertainty" which in turn reduces investment and the hiring of labor. As the fog clears, entrepreneurs

[7] See Romer and Bernstein (2009)

realize that the general economic environment has changed. New entry and profit opportunities for entrepreneurs have been reduced while at the same time economic policy is delaying the exit of firms suffering large economic losses. In other words, the price system is hampered and the economy is no longer competitive. It would be hard to disagree with Ben Powell (2009, p. 20) who characterizes the current political environment as one of "regime worsening."

THE LESSON OF HOOVER AND BUSH

The lesson of Hoover and Bush is to avoid the temptation to deploy interventionist policies in the face of an economic crisis. To be panicked into interventionist policies is to be lured by the ephemeral hope that man can control and manipulate a society without causing a multitude of unintended consequences. The result is a worsening of the economic crisis, economic depression, and stagnation. For Hoover and Bush, it is the humiliation of history. While the history of the current crisis has yet to be fully written, there is already a striking parallel taking shape between Roosevelt's following of Hoover's lead and Obama's similar amplification of Bush-era economic policies. In each case the follower builds on the agenda of the leader. If these parallels continue, it implies difficult times ahead.

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