

# Why the U.S. Economy Is Not Depression-Proof

*Mark Skousen*

If the monetary policies of the 1920s brought forth the Great Depression, similar policies during the 1980s are likely to produce another depression.

—Hans F. Sennholz<sup>1</sup>

**I**n 1954, Milton Friedman delivered a lecture in Stockholm, Sweden, entitled, “Why the American Economy Is Depression-Proof.”<sup>2</sup> In many ways, his published speech symbolized the new bold optimism of the contemporary economists in a post-Keynesian world. Economists and government officials, according to Friedman, have sufficient understanding of the inter-workings of the whole economy and the technical tools with which to prevent an economic downturn from turning into a full-scale depression. While considered a maverick on most subjects, on this issue the illustrious Chicago economist joined the chorus of neoclassical orthodoxy in unanimously proclaiming that another 1930s-style debacle is impossible.<sup>3</sup>

Friedman referred to several institutional changes made by government since the 1930s that would “render a major depression in the United States almost inconceivable at the present time.”<sup>4</sup> These fundamental developments included the establishment of federal insurance on bank and savings deposits, the abandonment of the gold standard, and the substantial increase in the size of government and the welfare state.

The demonetization of gold was a critical step in the Federal Reserve’s ability to ward off a major slump. Friedman cogently argued that defending the gold standard during a period of credit expansion would eventually force a monetary collapse, as it did in 1929–33. The removal of any barriers to monetary inflation is essential, he said, since “there has been no major depression that has

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not been associated with and accompanied by a monetary collapse.”<sup>5</sup> In short, Friedman believes that a depression can be avoided as long as the money supply does not decline.

Friedman’s lecture was given at a time when there was considerable concern that a mild recession in 1953 would degenerate into a major depression. He cited Colin Clark, a prominent British economist, as one who held this pessimistic view. But the Chicago monetarist denied such a possibility, stating confidently that “anything more than a minor economic recession is extremely unlikely.”<sup>6</sup> Over the longer term, he forecast “a period of recurrent bouts of inflation produced by overreaction to the temporary recessions that punctuate the period.”<sup>7</sup> He also predicted that the inflation would not turn into a runaway inflation.

Friedman’s lecture has proven remarkably prophetic so far. The 1953 recession ended officially in mid-1954. Since then, the United States has experienced a series of economic expansions, punctuated by occasional contractions, but none severe enough to qualify as a 1930s-style depression. Throughout the past thirty-five years, the economy has faced a general rise in consumer prices, but no runaway inflation.

### **Have Friedman’s Views Changed in Thirty-five Years?**

What about today? In the face of the stock market panic in October 1987 and renewed predictions of either depression or runaway inflation, does Friedman see things differently? Apparently not. Referring to his 1954 lecture, he recently wrote: “I have seen no reason since then, and see none now, to change that conclusion.”<sup>8</sup> Furthermore, he states elsewhere:

I do not expect any repeat of the Great Depression. I expect another garden-variety type of recession unless you have strongly protectionist trade legislation come out of the Congress plus undesirable tax increases. In that case, the betting is off and the recession might be much more severe than I now anticipate.<sup>9</sup>

### **Why the American Economy Is Now Vulnerable**

My thesis is that Friedman’s “built-in stabilizers” are not a sufficient condition to prevent the U.S. economy from suffering a devastating economic debacle some time in the future.<sup>10</sup> For several reasons to be outlined shortly, I believe that the U.S. economy suffers from certain structural defects that under the right circumstances could precipitate a financial disaster similar in scope to the 1929–32 crisis.

I am well aware of the fact that numerous free-market economists and hard-money investment advisors have predicted economic calamity over the past two decades.<sup>11</sup> So far their dire forecasts have not materialized because they underestimated the government's ability to defuse the crises and postpone deflation. But now I believe we are entering a new era that could be more dangerous than the 1970s or 1980s. Although a future economic crisis may not produce the degree of unemployment and other marked effects associated with the Great Depression in the 1930s, it could involve a substantial reduction in the standard of living of most Americans for a period of time.

## **The Definition of a Depression**

Before presenting my arguments, I need to make clear what is meant by a depression. The same question was asked of Friedman following his lecture in Sweden. Friedman adopted the traditional view of defining a depression in terms of the level of unemployment. Although admitting that the distinction between a recession and depression is statistically imprecise, Friedman said, in essence, that he would consider an 8 percent unemployment rate to be a "mild recession," 8 to 13 percent to be a "severe recession," and 14 to 25 percent or more to be a "depression."<sup>12</sup>

The economic emergency I am expecting could conceivably cause the rate of unemployment to reach 15 percent or more, but the definition of depression should include other measurements in addition to the level of unemployment. The definition of depression should be expanded because, in an age where the government views itself as an employer of last resort, the country could face a severe depression while official unemployment statistics may remain artificially low due to ubiquitous government hiring.

In many socialist countries, the government is the principal employer. Consequently, officially there is little or no unemployment, even though citizens are undoubtedly employed in an inefficient manner (commonly referred to as "underemployment"). It is quite conceivable that an economic crisis could be of such magnitude in the United States that the federal government would attempt to employ millions of Americans, in a civilian or military status, in an effort to keep official unemployment statistics politically acceptable. Such a makeshift solution might be a way of spreading the misery around, but it would not eliminate the misery and would, in fact, increase it by reducing the incentive for productive citizens to work.

A depression should be properly defined as a substantial decline in the standard of living. A common way to determine material well-being is to measure the year-to-year change in individual income levels, adjusted to account for changing purchasing power of the national currency. It is imperative that nominal incomes be adjusted by price changes. In the case of a deflation, price reductions would enhance nominal income. In the case of an inflation, especially

a runaway inflation, price increases would be detrimental. History has shown that depression—that is, substantially lower standards of living—is possible in times of either rising or falling prices. While price figures may not be accurate, especially if they are manipulated by the government data gatherers, they can reflect the general decline in people's material well-being. Therefore, as a rule of thumb, I would define a depression as a period of time (say, one to five years) when average real incomes decline substantially (say, 30 percent or more). This decline in real income would undoubtedly coincide with significant unemployment and underemployment of labor and resources. In short, the United States and other western countries could suffer from serious macroeconomic disequilibrium.

The use of per capita real income may not completely capture the depth of an economic downturn, however. It does not take into account, for example, the number of family members that may be forced by economic necessity to seek employment. The increasing number of women in the work force in the 1970s and 1980s was not simply a response to the women's liberation movement, but reflected the increased necessity of earning a higher family income in order to maintain the same standard of living in an inflationary environment. Furthermore, if the government placed large numbers of the unemployed on its payroll, per capita income figures might not reflect the sharp decline in the standard of living.

### **Worse than 1929?**

In order for a future depression to be “worse than 1929,” as Hans Sennholz predicts, we would need to see:

1. Gross national production (in real terms) decline by more than 30 percent,
2. Per capita personal income (in real terms) drop by 28 percent or more,
3. Private investment (in real terms) fall by more than 86 percent,
4. Stock prices plunge by more than 80 percent,
5. The unemployment rate climb by over 25 percent,
6. Retail prices drop by an average of 24 percent, wholesale prices by 31 percent, and raw commodity prices by 42 percent,
7. The business bankruptcy rate rise by 50 percent or more, and
8. Nearly half the commercial banks fail.<sup>13</sup>

The magnitude of the Great Depression is overwhelming; it is hard to conceive of it happening again. The two worst recessions the United States has experienced since the 1930s occurred in 1973–75 and 1980–82. If we examine

**Table 1**

**Recent Recessions versus the Great Depression: Selective Statistics**

<i>Factor</i>	<i>1929–32</i>	<i>1973–75</i>	<i>1980–82</i>
Real GNP	– 30%	– 3%	– 1%
Per capita real income	– 28%	– 1.1%	0.0%
Private gross investment (real)	– 86%	– 31%	– 22%
Unemployment	25%	8%	11%
CPI	– 24%	+ 26%	+ 30%
Stock prices	– 88%	– 45%	– 25%
Money supply (M1)	– 21%	+ 9%	+ 16%
Government expenditures as a percent of GNP	10%	35%	40%

Source: *Statistical Abstract of the United States* (Washington, D.C.: U.S. Department of Commerce, 1980, 1987); *Historical Statistics of the United States: Colonial Times to 1970*, (Washington, D.C.: U.S. Department of Commerce, 1975); and *Business Conditions Digest* (Washington, D.C.: U.S. Department of Commerce, 1987).

Note: Stock prices based on New York Stock Exchange Composite Index.

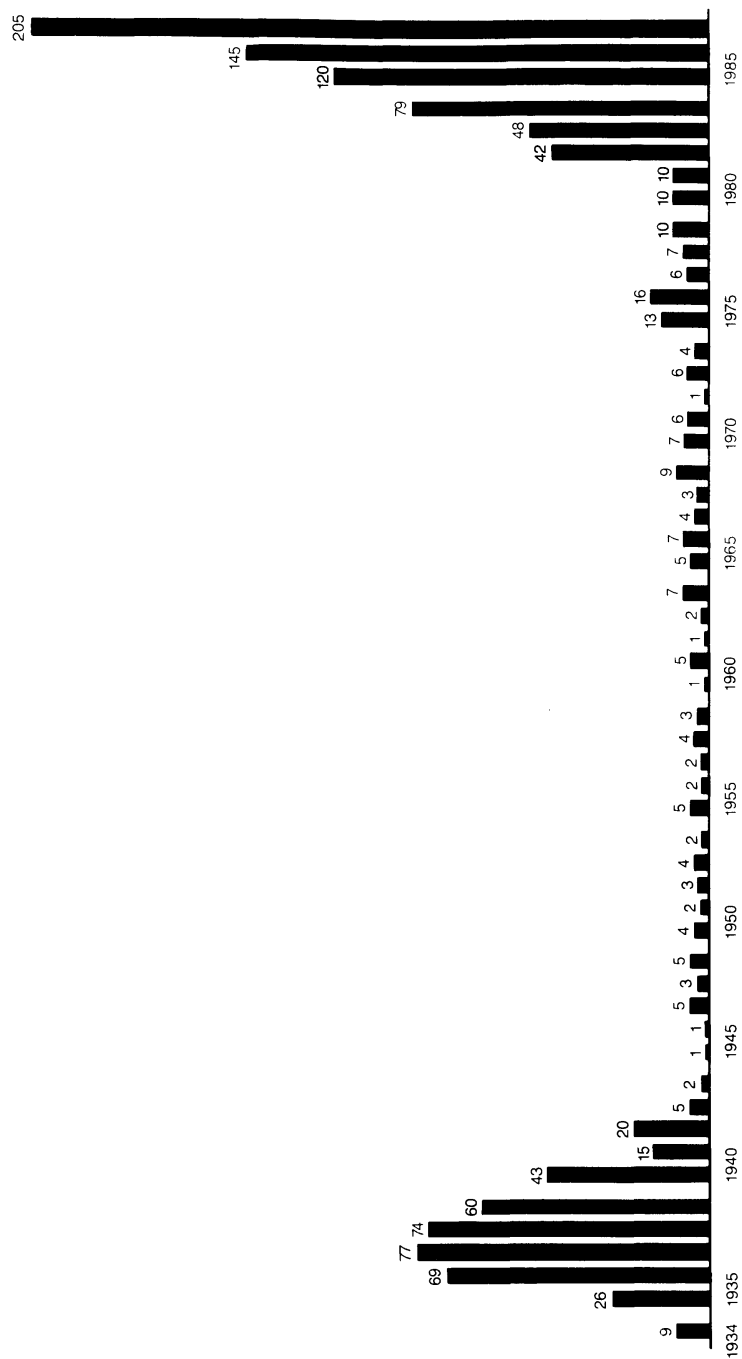
in table 1 a few selective statistics, we see that the 1973–75 and 1981–82 recessions pale by comparison.

Undoubtedly the substantial increase in the size of government played a significant role in preventing the GNP from declining much during the recessions in 1973–75 and 1980–82. On the other hand, the large size of government did not prevent private investment from falling sharply and unemployment from rising significantly. Another important observation is that the money supply, as measured by M1 or M2, did not decline in absolute terms during 1973–75 and 1980–82. Nevertheless, the economy suffered two severe recessions. Despite Friedman's contention that a depression is impossible without a contraction in the money supply, it is clear that a severe economic recession is conceivable even while the central bank continues to inflate.

Still the question remains: what catastrophic event could precipitate a depression equal or greater in magnitude than 1929–32?

## **Instability and the Banking System**

I begin my case with a central point on which Friedman and I agree: whether or not we have another depression depends primarily on the banking system. The banking system is the linchpin of financial and economic stability in the world. The only way the economy could collapse (other than by war or acts of God) is by the public losing faith in the monetary system of this country. I do not accept the popular conservative view that an excessive national debt could alone cause a depression.



**Figure 1. U.S. Bank Failures, 1934-85**

Source: VERIBANC, Inc. (Woburn, Mass. 01888) 1988; from Federal Deposit Insurance Corporation Statistics. Reprinted with permission.

The recession turned into a depression primarily in the 1930s because of bank failures, which in turn caused the money supply to decline dramatically. (However, the length of the 1930s depression was inordinately long due in part to the inflexibility of wages and other forms of government intervention.) Because of the extremely low level of cash reserves held by the commercial banks in the early 1930s, the demands for cash by nervous depositors resulted in a nationwide financial panic; one bank failure led to another, and in the end, there was a massive contraction in the monetary aggregates.<sup>14</sup>

Friedman maintains that the establishment of federal deposit insurance has virtually eliminated banking panics and bank failures. "In my view, the federal insurance of deposits is by all odds the most important of these changes in its effects on the cyclical characteristics of the American economy." More to the point, "Federal deposit insurance has made bank failures almost a thing of the past."<sup>15</sup>

While his statement about bank failures was accurate in 1954 and in 1968, when he updated the article for *Dollars and Deficits*, it is no longer true, especially since the early 1980s. Figure 1 shows that the number of U.S. bank failures is growing rapidly.

There is little evidence that this alarming trend is abating. According to Veribanc, Inc. (a private independent rating service of U.S. financial institutions), the banking industry in general has been steadily deteriorating since the early 1980s, based on a variety of indicators. Using data provided by the Federal Deposit Insurance Corporation (FDIC) and other bank regulatory agencies, the number of banks operating at a loss is substantial. In the fourth quarter of 1987, 3,554 banks (or 26 percent of all commercial banks) were losing money. (This is down slightly from the fourth quarter of 1986, but banking experts considered it an anomaly.) During 1985–87, the number of banks classified in Veribanc's "red" category, signifying those banks that will be forced into liquidation if losses continue at the same rate, increased from 514 to 635. The number of commercial banks declined slightly, from 14,344 to 13,616, even though the economy was in the midst of the Reagan boom.

The financial condition of the savings and loan industry is much worse. The number of S&Ls operating at a loss increased from 679 in the fourth quarter of 1985 to 1,068 in the fourth quarter of 1987. Nearly one-third of all S&Ls have a tangible net worth below zero.

Figure 2 demonstrates the secular trend in the banking industry in terms of the number of federally insured commercial banks that could reach zero equity in less than twelve months.

## Is Federal Insurance Destabilizing in the Long Run?

What can explain the secular deterioration in the banking industry? Perhaps one of the reasons long-term instability has been the fact that banking

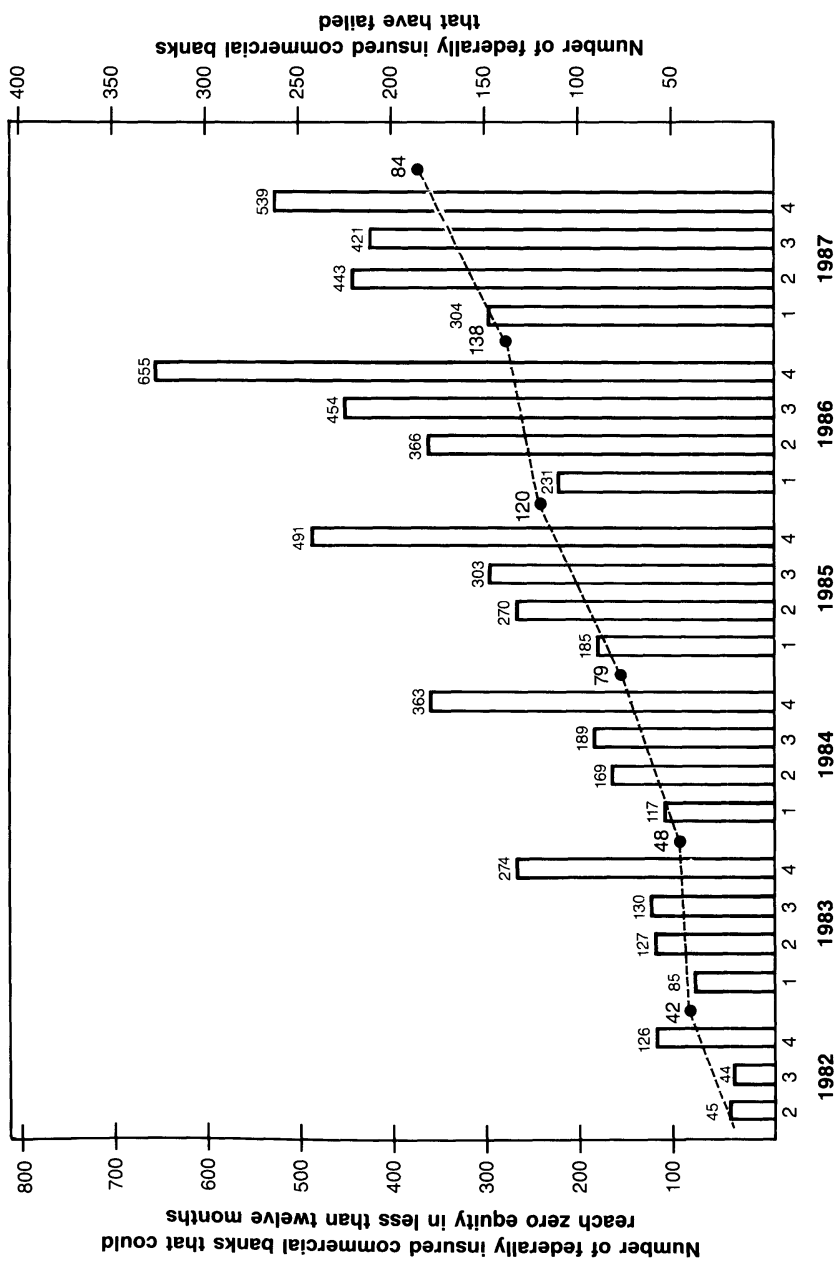


Figure 2. Deterioration of the Banking Industry, 1982-87.

Source: VERIBANC, Inc. (Woburn, Mass. 01888) 1988; from Federal Reserve Statistics. Reprinted with permission.



deregulation has been a gradual process, in contrast to the airline industry, which was quickly deregulated in the early 1980s and appears to have achieved relative stability by the late 1980s.

Part of the responsibility may also rest with federal insurance itself. Under current law, checking and savings deposits are guaranteed up to \$100,000 per account by a federal agency. By making customers' deposits virtually risk-free investments, the government is indirectly encouraging bank managers to take greater speculative risks. The theory is that financial officers will take greater chances with depositors' funds if depositors are unconcerned about the quality of the bank's portfolio. This appears to have been the case in the 1970s and early 1980s, when major banks across the country invested in high-risk deals in oil, real estate, and Third World obligations. In the long run, all forms of government intervention backfire.

Moreover, a majority of investors ignore the safety of banks and simply seek out the highest yields on CDs, encouraging the growing problem, especially in the S&L industry, of paying above market yields on savings deposits in a desperate attempt to avoid default.

As it now stands, it will require substantial injections of new funds to cover the insured liabilities of customers' funds in banks and savings institutions that will fail over the next few years. The FDIC currently has reserve assets worth only 1.2 percent of the \$1.75 trillion of insured commercial-bank deposits. Of the FDIC's \$20 billion in reserves, a large portion is comprised of yet-to-be-sold assets of failed banks. Veribanc estimates that liquid funds amount to between \$4 billion and \$10 billion, representing a mere 0.5 cents of available FDIC reserves per dollar of insured deposits.

The Federal Savings and Loan Insurance Corporation (FSLIC) publicly acknowledged its insolvency in 1987. Congress issued \$10.8 billion in bonds to recapitalize the FSLIC. However, recent closures and consignment actions against several large thrifts have already drawn on a significant portion of this amount. The 339 S&Ls that were insolvent by regulatory standards at the end of 1987 were continuing to lose money at the rate of \$9 billion a year, with the regulatory net worth of these institutions amounting to a negative \$14 billion. Veribanc estimates that the total tangible net worth of all savings institutions was minus \$54.4 billion in 1987. It believes that Congress will be required to inject between \$25 billion and \$50 billion into the FSLIC over the next few years to pay all the liabilities of the defaulted banks.

## **How Fragile Is the Financial System?**

Because the commercial banking and savings structure is still built on a fragile fractional reserve system, a widespread distrust of the banks by the general public could cause a massive hemorrhaging of the financial system. If the United

States adopted a 100 percent reserve system, as Friedman and other monetarists have advocated in the past, the financial system would be on a much sounder basis and would make a credit collapse highly improbable.<sup>16</sup>

Unfortunately, however, the United States has not removed this point of instability. Hence, the banking system is just as vulnerable as it was in the 1930s, in terms of low cash reserves in relation to demand deposits. Under the Depository Institutions Deregulation and Monetary Control Act of 1980, most financial institutions are required to maintain only 12 percent of their checking-account deposits in the form of cash (bank notes) or non-interest-bearing reserves at the Fed. (See table 2 for reserve requirements.)

The government has demonstrated its ability to control the financial system in the face of large bank failures, as in the case of the Continental Illinois Bank in 1984. As long as only a few banks fail, occasionally, the government should be able to contain the ongoing crisis and keep it from spreading throughout the country. While the number of annual bank failures has risen sharply since 1980, it has not yet approached the level of the 1930s depression, when nearly half the commercial banks closed their doors permanently. However, if numerous financial institutions (including several large banks) begin closing their doors, there could be a universal effort by customers to convert deposits into cash. The result would be a massive liquidity squeeze. Theoretically, only 12 percent of checking-account customers would be able to obtain cash, although, in reality, the figure is significantly lower since most reserves are actually held in a noncash form at the Fed. The percentage is even smaller for holders of savings accounts and time deposits because of lower reserve requirements. Commercial banks in fact have only approximately \$24.5 billion in actual cash (coins and currency) on hand, according to the Veribanc. This represents only a minuscule 4.5 percent of checking-account deposits, and 1.3 percent of all savings deposits! Depending on the severity of the crisis, the

**Table 2**  
**Legal Reserve Requirements under 1980 Banking Act**

<i>Type of Deposit</i>	<i>Reserve Requirement</i>	<i>Range in Which Fed Can Vary</i>
Checking accounts		
First \$30 million	3%	no change allowed 8–14%
Above \$30 million	12%	
Time and savings deposits		
Personal	no required reserves	
Nonpersonal		
Up to 1½ years maturity	3%	0–9%
Maturity of over 1½ years		0–9%

Source: Paul A. Samuelson and William D. Nordhaus, *Economics* (New York: McGraw-Hill, 1985), p. 275.

Fed would have to transfer huge amounts of currency to individual banks and call upon the Bureau of Engraving and Printing to increase the production of new bank notes on a massive scale.

At the present time, the money supply, M1, is approximately \$770 billion, while currency in circulation is \$223 billion, or 29 percent of M1. Thus, if a sizable portion of the population wished to convert bank deposits to cash, the government would face a serious shortage of the supply of currency, which has a theoretical demand of over \$500 billion. And that counts only the checking-account deposits, not time deposits. It might take months for the Treasury to fulfill the demands for cash. Banks and savings institutions have the legal right to impose a thirty-day moratorium on savings withdrawals, but no such restriction exists on checking-account deposits.

A moratorium on bank withdrawals may be inevitable in a liquidity squeeze as a result of another common banking practice: the mismatching of maturities between deposits and loans (what is frequently referred to as borrowing short and lending long). Checking accounts and passbook savings deposits are usually repayable on demand, while loans to individuals and businesses are repayable over long periods of time. Even the maturity dates on certificates of deposit are not usually matched with the repayment dates on loans. Harry Browne concludes: "It's possible that 90 percent of the banks in the U.S. are vulnerable to anything that could cause depositors to want to withdraw unusual amounts of money—while the banks are powerless to recover the necessary funds earlier from their borrowers."<sup>17</sup>

## **The Interdependence of Banks**

Another potential weak point in the banking system is the interdependence factor. Commercial banks and savings institutions are highly interconnected with each other. Smaller regional or state banks maintain deposits and purchase CDs from larger institutions in New York, Chicago, San Francisco, and other financial centers. It is also a common practice for smaller banks and S&Ls to sell commercial loans and mortgages to large financial institutions. Sometimes a small but aggressive bank can destabilize the whole banking industry. For example, Continental Illinois Bank and SeaFirst Bank in Seattle bought oil-related loans from Penn Square Bank, a relatively unknown institution in the Midwest. When Penn Square's billion-dollar loan programs went bankrupt in the early 1980s, it caused a serious run on Continental, the eighth largest commercial bank in the United States, and destroyed the equity value of SeaFirst's shareholders. SeaFirst had to be bought out by BankAmerica, and Continental Bank had to be bailed out by the FDIC. More recently, the FDIC has come to the rescue of another large bank, First RepublicBank of Dallas. It remains to be seen what impact failed Texas banks will have on the rest of the country.

The federal government, always aware of a potential liquidity crisis, has made contingency plans to prevent bank runs in isolated cities from spreading elsewhere. Among other control measures, the Monetary Control Act of 1980 gives the president emergency power to declare bank holidays in specific cities in the United States where bank runs may be happening.

## **The Engine of Macroeconomic Instability**

What could bring about a wholesale banking crisis and subsequent worldwide depression? The primary force is the increasing instability in fiscal and monetary policies of western governments. The inflationary policies of the West have created a monstrous boom–bust cycle that has gradually worsened over the past thirty years. The effects have been felt both regionally and nationwide. As a result, banking and corporate balance sheets have gradually deteriorated, especially after each recession.

Nonfinancial corporation debt in the United States reached \$1.8 trillion in 1987, triple the \$586.2 billion total in 1976. Interest payments have risen sharply, companies' liquidity has fallen, and credit quality has suffered. As Mickey D. Levy, chief economist of First Fidelity Bank Corp. in Philadelphia, warns: "Once the economy begins to weaken, as it sooner or later will, the high levels of corporate debt will exacerbate the downturn."<sup>18</sup>

Government-induced inflation via the credit markets does not simply raise prices in a relatively innocuous manner; it also creates massive distortions in the macroeconomic structure. It induces billions of dollars to be spent in wasteful malinvestments in the capital-intensive industries (e.g., real estate, oil and gas, plants and equipment, durable goods, and long-term projects).<sup>19</sup> Such an excessive speculative boom in the capital markets cannot last and eventually must be liquidated in the contractual phase of the business cycle. In essence, too many long-term projects and durable capital goods are produced for which there is ultimately insufficient demand. While it is difficult to quantify the level of malinvestments at any time, the degree of imbalance becomes apparent during a recession.

The United States and other western nations have been willing to endure recessions, even severe downturns, since World War II, and this development has been healthy in promoting a return to a stable and permanent economic recovery. However, it is apparent that government officials are unwilling to permit a complete liquidation of the malinvestments in the economy, which would require a full-scale deflationary depression, except on a regional basis as evidenced in the oil and agricultural depressions in the Midwest. Thus, every time the country has reached the brink of a severe recession, the government has stimulated another credit expansion to avert an economic collapse. The country's leaders are apparently afraid to let market forces determine the bottom

of the economic contraction. One gets the impression that if the Fed did not reflate, the economy would eventually collapse as the market sought to reestablish the real time preferences of individuals.

### Hayek's Rule of Monetary Acceleration

In the 1930s, Hayek argued that the only way for government to avoid an economic downturn after an inflationary expansion is to accelerate the level of monetary expansion. I call it "Hayek's Rule of Monetary Acceleration."<sup>20</sup> Hayek stated that "in order to bring about constant additions to capital, it would have to do more: it would have to increase [credit] at a *constantly increasing rate*."<sup>21</sup>

Federal Reserve policy in the 1980s may be a classic manifestation of Hayek's Rule, as reflected in figure 3. It shows the quarter-to-quarter changes in M1 from 1960 to 1988. It is clear from the chart that (1) monetary expansion is becoming more and more inflationary and (2) monetary policy is

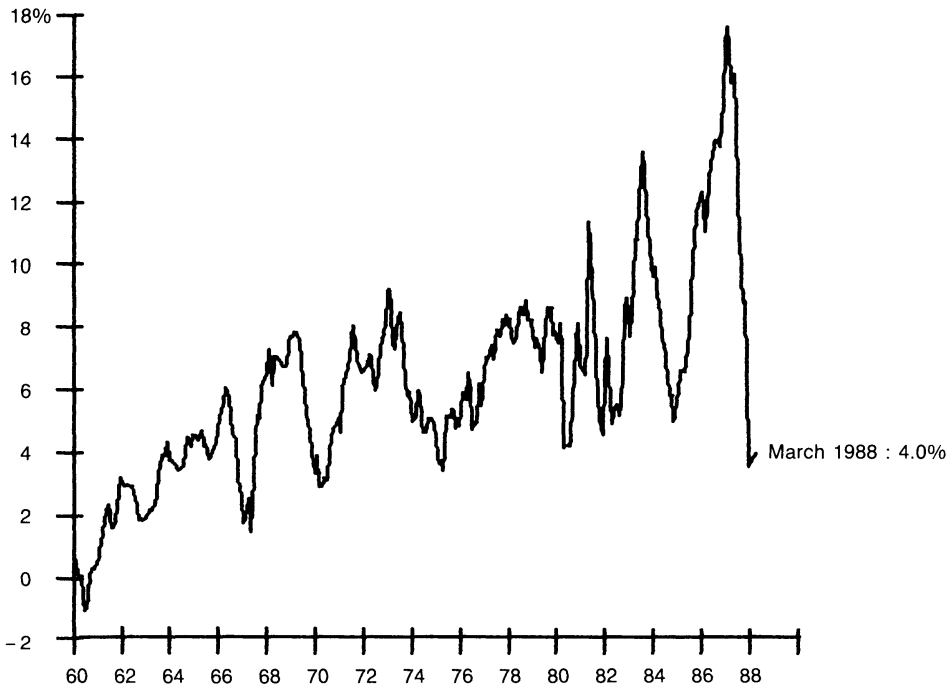


Figure 3. Quarterly Changes in U.S. Money Supply (M1), 1960–88

Source: Ed Hyman; C.J. Lawrence, Morgan Grenfell Inc., New York.

becoming more and more volatile. In 1979, the maximum increase in M1 was 9 percent; in 1981, 12 percent; in 1983, 14 percent; in 1986, 18 percent.<sup>22</sup> Every attempt by Fed officials to “fight inflation” has ended abruptly a few years later as fears of a recession/depression surface. Friedman compares monetary policy to a driver turning the steering wheel of a car and hitting one side of the road and then veering over to the other side of the road. But then there is the danger that the driver will give “the steering wheel a jerk that threatens to send the car off the road.”<sup>23</sup> Judging from recent monetary policy, the driver is becoming a reckless madman at the wheel.

The reflation efforts of the Fed are not entirely a voluntary decision. According to Hayekian theory, the Fed cannot adopt a monetarist rule of increasing the money supply at a steady rate (3–5 percent) without causing a severe downturn in economic activity. Friedman himself admits this to be the case and advocates a gradual reduction in monetary inflation until a low monetary rule can be established on a permanent basis. But the Fed has not been so patient, apparently abandoning the use of money-supply targets in the early 1980s. The reason can be traced back to the Hayekian theory of macroeconomic disequilibrium. That is, if the central bank inflates the money supply at double-digit rates via the credit markets and then adopts a monetary rule below the previous rate of inflation, the effect will be a serious recession revealing the malinvestments in the capital-goods industries. Credit-oriented inflation presupposes a bust at some point.<sup>24</sup>

The longer monetary authorities maintain a “no-recession” policy, they increase the risk of runaway inflation. This is the inevitable result of Hayek’s Rule. Figure 3 indicates that the United States is gradually moving in that direction. The next time the Fed panics, M1 may accelerate to a 25–30 percent rate if the M1 trend continues. This suggests the possibility that if a depression threatens the country, the central bank will attempt to inflate its way out. Moreover, given the emergency powers granted to the executive branch and the immense size of the federal government, it is quite conceivable that Washington will impose severe economic controls in an effort to contain the crisis.

## **The Increasing Risk of a Financial Accident**

Microeconomic *laissez-faire* tends to undermine macroeconomic interventionism. As central banks reach higher and higher levels of monetary hyperextension, they increase the risk of precipitating a financial accident. Specifically, in the face of such extreme instability, many individuals, corporations, and institutions in the United States and elsewhere may seek to avoid a perceived disaster by acting early to eliminate debts, build a strong cash position, sell assets, buy gold, hoard currency, and so on. Anticipating deflation, some investment companies, banks, and speculators may withdraw suddenly and unexpectedly from major positions in securities, bonds, and deposits. There

may be a run on the dollar, just as there were occasional runs on gold under the pre-1971 gold standard. There is no question that western governments are deeply concerned about the possibility of a worldwide panic in the foreign currency markets. Floating exchange rates do not eliminate speculative fever. As Sennholz states: "With floating exchange rates . . . any event, no matter how small, could trigger strong speculative movements that would cause exchange rates to fluctuate widely."<sup>25</sup>

Milton Friedman notes significantly that in the autumn of 1931, after England went off the gold standard, the Federal Reserve authorities feared a gold drain from the United States. Friedman records:

Although their gold reserves greatly exceeded legal requirements and were extremely high by any absolute standard, they succumbed to something approaching panic and proceeded to take strong deflationary measures, putting up the bank rate more sharply and suddenly than at any previous time in their history—and this after two years of economic contraction. . . . True, the Reserve system reversed its policy in early 1932 and undertook moderately expansionary measures; but by then it was too late. Measures of this magnitude might easily have saved the day in 1931; by 1932 they were utterly inadequate to stem the raging tide of deflation that the Reserve system had unleashed.<sup>26</sup>

One wonders whether today's monetary system is that much different from that of the early 1930s. Certainly the international dollar standard makes it possible for inflation to last much longer than it could under a strict gold standard. Nevertheless, the Federal Reserve continues to adopt tight-money policies from time to time in an effort to temper inflation and bolster the U.S. dollar on foreign-exchange markets. Such actions are reminiscent of previous efforts to defend the gold standard. The Fed took strong "anti-inflation" action in 1979 under Chairman Paul Volcker and again under Alan Greenspan in 1987. Could an inordinate concern over the value of the dollar overseas lead Fed officials to repeat history by allowing monetary policy to remain too tight for too long? As in 1932, the Fed may eventually recognize its mistake, but it may be too late this time to stem the raging flood of deflation. The question becomes: have Federal Reserve officials learned from their mistakes of the past, or will they behave as recklessly as they did in the early 1930s? Having observed their actions of the past thirty years (as evidenced in figure 3), I see no reason to have confidence in them in the future. Serious if not fatal mistakes will be made over the next several years, any one of which could produce a worldwide financial panic and economic depression.

## **The Stock Market Panic of 1987**

The October 1987 stock-market debacle was worldwide in scope. The initial downturn in the financial markets was caused by the Fed's tight-money policy

and rising interest rates in 1987. The 508-point drop in the Dow Jones Industrial Average on October 19 was a classic panic, reflecting a series of bad economic news, the herd-like instinct of technical-trading systems, and ultimately the complete loss of confidence in the financial system by individual investors and institutions. But what was even more disturbing was the liquidity crisis that hit the day after on October 20, an event hardly publicized until weeks later. *The Wall Street Journal* reported:

Phone calls started pouring into officials at the Big Board and the Federal Reserve Bank of New York. Angry securities dealers reported that foreign and U.S. regional banks were cutting back credit to the securities industry. Bankers Trust told Wall Street firms that it would stop extending unsecured credit—loans not collateralized by assets.

Executives at one big Wall Street securities firm were shocked when another U.S. bank Tuesday refused to deliver promptly \$70 million in West German marks that it had sold to the firm in a foreign-exchange trade. Apparently, the bank feared that it might not be paid promptly—if at all—for the marks. . . .

After learning of the credit squeeze facing Wall Street, Messrs. Greenspan and Corrigan [president of the Federal Reserve Bank of New York] feared that something far worse than a stock-market panic might be in the offing. If credit dried up, securities firms could start to collapse, much as the banks did after the 1929 crash. Fed officials saw a real threat of gridlock developing in the markets: Even the simplest financial transaction might have become impossible.<sup>27</sup>

In short, the stock-market crash had all the markings of a financial accident that could have closed major markets indefinitely. Of course, the Fed intervened and prevented it from happening by guaranteeing the banks' unsecured credit to security dealers. But it is precisely this type of unexpected event that can trigger a worldwide panic, one that may not always be so easily resolved by monetary authorities.

Were the banks beneficiaries of the collapse in stock values? After the stock-market crash, one economist told *Time* magazine: "In the 1930s when things looked bad, people ran from the banks out of fear. In 1987 people run to the banks to put their money in, because this time the banks are among the safest things around."<sup>28</sup> This viewpoint is not entirely accurate, however. Many investors withdrew cash from their bank accounts following the stock-market collapse. There were reports that many banks were short \$100 bills. Nevertheless, the economist has a point. If the public maintains confidence in the banking system, the possibility of another depression is remote. But if the banks are viewed with grave suspicion and inadequately prepared to handle large cash withdrawals, another economic collapse is a very real threat.

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## The Increased Size of Government: Boon or Bane?

Friedman and other neoclassical economists argue that the increased size of government is a “built-in stabilizer” in preventing another depression. Table 1 demonstrates how government has grown since the Great Depression.

Federal, state, and local spending programs played a key role in sustaining the economy and were the principal reason why real GNP declined only a fraction during the 1973–75 and 1980–82 recessions. On the other hand, an expanding state can be a serious drag on the economy in terms of confiscatory taxes and bureaucratic rules for private enterprise and inefficient supply of public services. If the government becomes too large and socialistic, it can cause a permanent depression that may not be evident in the government statistics. The burgeoning state may not be reflected in unemployment figures, but underemployment and underproductivity will be evident everywhere.

### Summary

The U.S. economy has been remarkably resilient over the years. In the turbulent 1970s, it was able to rebound from the energy crises, food shortages, and double-digit inflation. In the disinflationary 1980s, it has had to overcome major credit crunches, volatile financial markets, and banking crises. In short, Armageddon has been postponed.

Nevertheless, while the United States and other western countries may be depression-resistant, they are not depression-proof. They are highly susceptible to deep recessions from time to time. Governments have been remarkably successful in averting disaster over the past fifty years. One wonders if Armageddon can be postponed indefinitely. So far, the government forces of inflation have effectively beaten back the free-market forces of deflation. But while the government has won many battles, the war is not over. Macroeconomic imbalance is still very much in evidence; and it is, in fact, growing as monetary and fiscal policies become more and more precarious. As long as the financial-banking system is built on a volatile, destabilizing inflationary policy coupled with a fragile fractional reserve system, the possibility of financial chaos and a subsequent economic cataclysm should not be discounted.

### Notes

1. Hans F. Sennholz, “Worse than 1929,” in Sennholz, *Debts and Deficits* (Spring Mills, Penn.: Libertarian Press, 1987), p. 89.

2. Milton Friedman, “Why the American Economy is Depression-proof,” in Friedman, *Dollars and Deficits* (Englewood Cliffs, N.J.: Prentice-Hall, 1968), pp. 72–96. Originally appeared in *Nationalekonomiska Foreningens Forhandlingar* (1954).

3. The only other economist I know who has written on this subject is Gottfried Haberler. Haberler offers an excellent review of all the major explanations of the Great Depression, including Austrian views, and concludes that another deflationary depression "is almost inconceivable," while an inflationary depression "is not unthinkable" and inflationary recession is more likely in the future. See Gottfried Haberler, "The Great Depression of the 1930s—Can It Happen Again?" in *Selected Essays of Gottfried Haberler*, Anthony Y.C. Koo, ed. (Cambridge, Mass.: MIT Press, 1985), pp. 405–26.

4. Friedman, "Why the American Economy Is Depression-proof," p. 74.

5. *Ibid.*, p. 79.

6. *Ibid.*, p. 89.

7. *Ibid.*, p. 90.

8. Milton Friedman, "1929 and 1987: The Differences," *National Review* (November 20, 1987).

9. Letter from Milton Friedman to the author, dated December 23, 1987.

10. It is inappropriate to set a specific timetable as to when another depression will happen. I do not subscribe to Professor Ravi Batra's determinist views that a deflationary depression is inevitable in 1990. See his *The Great Depression of 1990* (New York: Simon and Schuster, 1987). Since economic events are determined by human action, not senseless machines, setting a specific date for an occurrence is an unscientific form of forecasting. Batra bases his prediction on past cycles. But history never repeats itself in exactly the same fashion. It is incongruous to compare the 1980s to the 1920s, year for year, as Batra does. There are similarities, but there are also major differences, such as the size of government. Strangely, despite Batra's claim that the depression is inevitable, he recommends that it can be avoided by the government imposing a wealth tax and rescinding the Reagan tax cuts. But the reduction in marginal tax rates may have been one of the few genuinely beneficial acts by the Reagan administration. Indeed, a reversal of these tax cuts might well cause a depression.

11. Predictions of imminent depression in the 1970s were made primarily by hard-money investment writers such as: Alexander Paris, *The Coming Credit Collapse* (New Rochelle, N.Y.: Arlington House, 1974); C.V. Myers, *The Coming Deflation* (Arlington House, 1976); Douglas R. Casey, *Crisis Investing* (Los Angeles: 76 Press, 1979); and Howard J. Ruff, *How to Prosper during the Coming Bad Years* (New York: Times Books, 1979).

12. Friedman, "Why the American Economy Is Depression-proof," p. 94. Friedman's estimates of unemployment are based on the U.S. civilian labor force in the early 1950s. At the beginning of his lecture (p. 72), he also refers to industrial production, GNP, prices, interest rates, and other data as a means of measuring economic activity.

13. Figures are based on data from *Historical Statistics of the United States: Colonial Times to 1970* (Washington, D.C.: U.S. Department of Commerce, 1975).

14. Milton Friedman and Anna J. Schwartz, *The Great Contraction: 1929–1933* (Princeton, N.J.: Princeton University Press, 1963), pp. 3–5.

15. Friedman, "Why the American Economy Is Depression-proof," p. 75.

16. The 100 percent reserve proposal is discussed in Friedman, *A Program for Monetary Stability* (New York: Fordham University Press, 1959), and Henry Simons, *Economic Policy for a Free Society* (Chicago: University of Chicago Press, 1948). To my knowledge, the 100 percent reserve concept has not been discussed recently by monetarists.

17. Harry Browne, *Why the Best-Laid Investment Plans Usually Go Wrong* (New York: William Morrow, 1987), p. 348. Browne and his associate, Terry Coxon, have outlined an intriguing “deflation” scenario in their book, *Inflation-Proofing Your Investments* (New York: Morrow, 1981), pp. 59–83.
18. “Borrowing Binge: Takeover Trend Helps Push Corporate Debt and Defaults Upward,” *Wall Street Journal*, March 15, 1988.
19. Studies on macroeconomic disequilibrium can be found in F.A. Hayek, *Prices and Production*, 2nd ed. (New York: Augustus M. Kelley, 1935); Murray N. Rothbard, *America's Great Depression*, 4th ed. (New York: Richardson and Snyder, 1983); and Gerald P. O'Driscoll, Jr., and Mario J. Rizzo, *The Economics of Time and Ignorance* (New York: Blackwell, 1985).
20. Hayek, *Prices and Production*, 2nd ed., pp. 148–52. See also Hayek, *Monetary Theory and the Trade Cycle* (London: Jonathan Cape, 1933), pp. 212–18.
21. Hayek, *Prices and Production*, p. 150.
22. Friedman prefers to use the broader-based M2, which includes money market funds, as a more consistent measure of monetary policy. He argues that since the introduction of money market funds in the late 1970s, M1 has become a misleading and narrow indicator of the money supply. M2 does not show the increasing volatility of monetary policy, although it does confirm the inflationary bias of the Fed. Interestingly, Friedman used M1 figures without reservation in his 1984 book, *Tyranny of the Status Quo* (San Diego: Harcourt Brace Jovanovich), to demonstrate the Fed's inflationary bias. I think his criticism of M1 as a narrow definition of money is valid, but M1 still reflects the direction of Federal Reserve policy, and it therefore cannot be ignored.
23. Friedman, *A Program for Monetary Stability*, p. 23.
24. Hayek, *Prices and Production*, pp. 148–49.
25. Hans F. Sennholz, *Age of Inflation* (Belmont, Mass.: Western Islands, 1979), p. 142. Chapter V, “The American Economy Is Not Depression-proof,” is a critique of Friedman's 1954 lecture.
26. Friedman, “Why the American Economy Is Depression-proof,” p. 81.
27. James B. Stewart and Daniel Hertzberg, “Terrible Tuesday: How the Stock Market Almost Disintegrated a Day after the Crash,” *Wall Street Journal*, November 20, 1987, p. 23.
28. “The Crash,” *Time*, November 2, 1987.

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