Party Like It's 1937

Dueling deficit-cutting plans, plus end of QE2, raise risk of premature withdrawal of stimulus. St. Augustine, let us pray. Just as the U.S. economy is emerging from a severe contraction caused by a credit crisis, there are pressures to tighten both fiscal and monetary policies in order to rein in an excessive budget deficit and stave off nascent inflation.

Sound familiar? It should, because that is precisely what happened in 1937. As students of economic history are aware, those shifts to restrictive policies on the budget and by the Federal Reserve set the stage of the second part of the Great Depression.

This is worth reminding ourselves after President Obama laid out his plans to reduce the federal deficit by some $4 trillion over the next 12 years. That follows a competing proposal by Republican Rep. Paul Ryan of Wisconsin that would reduce the deficit by an aggregate $4 trillion in 10 years. And last year, the bipartisan Deficit Commission put forth a plan to cut the deficit by $4 trillion by 2020.

For the first time in my lifetime, the major parties are competing on how to cut the federal budget deficit. Things have turned 180 degrees. Now, from Tea Partiers on the right to Big Government liberals on the other side, nearly everybody is in favor of reducing the federal deficit. Who wants more red ink? But as St. Augustine is famously quoted as praying, "Lord, make me chaste, but not yet."

The history of the 1930s is the best example available to us. After contracting by more than 30% in 1929 to 1933, the U.S. economy grew more than 9% per annum in the next four years. The recovery began in March of 1933 — before Franklin D. Roosevelt took office — but after the Federal Reserve embarked on large-scale purchase of U.S. government securities, which would be called quantitative easing today.

In 1936, however, sharp rises in income taxes were enacted. Beginning in August of that year, monetary policy was tightened through a doubling of bank reserve requirements to absorb excess reserves that were thought to threaten inflation. That sounds awfully like what's in prospect.

Now, both parties have put forth proposals to reduce the federal deficit drastically. At the same time, the Fed is winding down QE2 and the debate on monetary policy is when — not if — the central bank should begin to sell off the assets it has acquired and begin raising short-term interest rates, which remain near zero.

There can be little argument that America's fiscal and monetary policies are unsustainable and actually untenable for the long term. Only the U.S. can get away with running trillion-dollar-plus budget deficits with T-bills paying virtually nil and 30-year bonds yielding only about 4.5%.

That's because America issues the currency the world uses for trade and financial transactions and as a store of value. Not even Coke, Marlboros or Microsoft Windows compare with greenbacks as a coveted American-made good around the globe. As a result, we Yanks get to consume more than we produce and save less than is invested here, with dollars run off the printing press making up the difference. Greece, Ireland and Portugal can't get away with that.

Things have come to a pretty pass, as the Gershwins wrote. We can't go on like this. But, as Nomura Research Institute chief economist Richard Koo warns, Japan tried to rein in fiscal deficits in 1997 and 2001, just as America did in 1937, with disastrous results. Raising tax rates and slashing spending while Japan was going through a balance-sheet contraction was counterproductive. Instead of trying to maximize profits, the private sector sought to minimize debt — despite zero interest rates.

That doesn't mean current policies are ideal; far from it. U.S. fiscal policy has provided a short-term palliative but little else to the economy. Cash for clunkers, housing purchase subsidies, temporary cuts in payroll taxes and extension of previous tax cuts don't provide permanent incentives; precisely the opposite, in fact, as the deficit swells to incomprehensible levels. While President Obama targets billionaires for tax hikes, those increases would hit the owner of the auto repair shop on Main Street hardest, who reports over $250,000 on his personal income tax return.

Meantime, QE2 has inflated asset prices for those sufficiently well-off to own stocks, as well as prices that ordinary folks pay at the pump and the supermarket, which are excluded from supposedly high-minded notion of core inflation. That leaves the dilemma — that current unsound policies are unsustainable, but putting them on a sound footing just now could be destabilizing.

Questions for Discussion *(50 words each)*

1. What are some of the things that the government has done in recent years to get us out of the economic downturn (both fiscal and monetary policy)? How have these policies worked?
2. Why does the government want to tighten both monetary and fiscal policy right now? What is the risk of doing this?
3. In what ways is our current economic situation similar to 1937? Be specific – what did the Fed do in 1936-37 and how is that similar to what the government is proposing to do now?