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Economic Myths and Irrelevancy

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Steve H. Hanke is a Professor of Applied Economics at Johns Hopkins University in Baltimore and Senior Fellow at the Cato Institute in Washington, D.C., and writes frequently for Globe Asia and Forbes magazine. Professor Hanke starts off his "Hu versus Sarkozy" article (Globe Asia, November 2009) with a warning. There is no more reliable rule than the 95 percent rule: 95 percent of what you read about economics and finance is either wrong or irrelevant. The article contrasts the Chinese versus the French responses to the financial crisis but the major focus is on economic myths.

Hanke says that the most repeated statement about the cause of the U.S. Great Depression is that it was caused by the October 1929 stock market crash. How could that be? By April 1930, the stock market had recovered to its pre-crash level. What is not taught in history books is the Great Depression was caused by a massive government failure. The most important part of that failure were the actions by the Federal Reserve Bank that led to the contraction of the money supply by 25 percent. Then, the name of saving jobs, Congress enacted the Smoot-Hawley Act in June 1930, which increased U.S. tariffs by more than 50 percent. Other nations retaliated and world trade collapsed. U.S. unemployment rose from 8 percent in 1930 to 25 percent in 1933. In 1932, the Herbert Hoover administration and a Democratic Congress imposed the largest tax increase in U.S. history, raising the top tax rate on income from 25 percent to 63 percent. The Roosevelt administration followed these destructive policies with New Deal legislation that massively regulated the economy and extended the Great Depression to after World War II.

Have today's politicians and their economic advisers learned anything from yesteryear's policy that turned what would have been a short, sharp downturn in the economy into a 16-year affair? The answer is very little. Professor Hanke argues that the chief enabler of both the Great Depression and our latest economic downturn is the Federal Reserve Bank, who sees itself as America's systemic risk regulator. This is the world upside down, Hanke explains: The Federal Reserve is the systemic risk.

How about a bit of history? Between 1787 and 1930, our nation has seen both mild and severe economic downturns, sometimes called Panics, that have ranged from one to seven years. During that interval, there was no thought that Congress or the president should intervene in the economy to enact stimulus packages, jobs programs or massive corporate handouts. Probably, the reason that no one thought to do so was that there was no constitutional authority to do so. It took the Herbert Hoover and Franklin Roosevelt administrations to massively and unconstitutionally intervene in the economy and, with the help of a frightened, derelict U.S. Supreme Court, turn what might have been a two- or three-year sharp downturn into our longest depression.

Professor Hanke says that the lesson to be drawn from business cycle history is that, if left to run their natural course, severe downturns are followed by rapid snapbacks. The 1921 recession is a good example where wholesale prices, industrial production and manufacturing employment fell by 30 percent or more and reached their low in mid-1921. There was little government intervention, at least by today's standards, and the economy recovered naturally; and by early 1922, it had fully recovered and the nation was off to the Roaring Twenties.

The bottom line is that the idea that government bureaucrats have enough knowledge to manage an economy well is the height of conceit -- what Nobel Laureate Friedrich Hayek called the "fatal conceit."