The New Deal of the 21st Century

With the election of Obama as president, the United States is facing an uncertain next four years. Given the promises made during the campaign and history, the United States could be facing “The Perfect Storm”, an economic depression and a national catastrophic event. The best advice that you can give the next president is to read and study history or as Edmund Burke said, “Those who don’t know history are destined to repeat it”.

The 1920’s were a time of peace and great prosperity. After World War I, the “Roaring Twenties” was fueled by increased industrialization and new technologies, such as the radio and the automobile. Air flight was also becoming widespread, as well. The economy benefited greatly from the new life changing technologies.

As the Dow Jones Industrial Average soared, many investors quickly snapped up shares. Stocks were seen as extremely safe by most economists, due to the powerful economic boom. Investors soon purchased stock on margin. For every dollar invested, a margin user would borrow 9 dollars worth of stock. Because of this leverage, if a stock went up 1%, the investor would make 10%. This also works the other way around, exaggerating even minor losses. If a stock drops too much, a margin holder could lose all of their money AND owe their broker money as well.

From 1921 to 1929, the Dow Jones rocketed from 60 to 400! Millionaires were created instantly. Soon stock market trading became America’s favorite pastime as investors jockeyed to make a quick killing. Investors mortgaged their homes, and foolishly invested their life savings in hot stocks, such as Ford and RCA. To the average investor, stocks were a sure thing. Few people actually studied the fundamentals of the companies they invested in. Thousands of fraudulent companies were formed to hoodwink un-savvy investors. Most investors never even thought a crash was possible. To them, the stock market “always went up”.

The commonly thought cause of the crash

- Stocks were overpriced and the crash brought the share prices back to a normal level.
- There were massive frauds and illegal activity in the 1920’s stock market. However, evidence revealed that there was probably very little actual insider trading or illegal manipulation.
- Margin buying is another reason why people believed that the crash happened. Though it is not the main reason, there was very little margin relative to the value of the market.

The real cause

The Federal Reserve, established in 1913, was the leading cause of the Great Depression.
The length and severity of the Great Depression primarily resulted from a disastrous monetary policy by the Federal Reserve followed by poor economic policy by the Federal Government.

Studies of monetary policy in the 1920s and 1930s now generally agree that Fed policy was too easy during most of the 1920s, turned sharply tighter in the late 1920s, and remained tight throughout the 1930s. Sound familiar?

From 1923 to 1929, wages rose; inflation, unemployment, and interest rates fell. The new President of the Federal Reserve Board, Adolph Miller, tightened the monetary policy and set out to lower the stock prices since he perceived that speculation led stocks to be overpriced, causing damage to the economy. Also, in the beginning of 1929, the interest rate charged on broker loans rose tremendously. This policy reduced the amount of broker loans that originated from banks and lowered the liquidity of non-financial and other corporations that financed brokers and dealers.

The Smoot-Hawley Tariff Act was an act signed into law on June 17, 1930, that raised U.S. tariffs on over 20,000 imported goods to record levels. In the United States 1,028 economists signed a petition against this legislation, and after it was passed, many countries retaliated with their own increased tariffs on U.S. goods, and American exports and imports plunged by more than half. In the opinion of most economists, the Smoot-Hawley Act was a catalyst for the severe reduction in U.S.-European trade from its high in 1929 to its depressed levels of 1932 that accompanied the start of the Great Depression.

Taxes were sharply raised in 1932 and 1935, and President Roosevelt's New Deal also bred a maze of government regulations that impacted heavily on business confidence that also contributed to the length and severity of the Great Depression.

But in the end, a protectionist trade policy in conjunction with mistaken Federal Reserve policies were the main factors that caused the U.S. economy to shrink by 27 percent between 1929 and 1933.

Is all this starting to sound familiar?

The commonly thought cause of today's problems

In the 90's technology and peace drove the economy, the automobile and radio of the 20's was replaced with the computer and communications revolution. The break up of the Soviet Union, and the so called peace dividend was the equivalent to the end of World War I. It was time to address the issues of the underserved.

Many believe that the cause of the housing market collapse was greed and bundled loans made to high risk borrowers off loaded to investors. As in 1929 what we see today is the results of a bad monetary policy by the Federal Reserve compounded by poor economic policy by the Federal Government. This resulted in a speculative housing market that when it collapsed left many borrowers with a negative equity. Obama's campaign promises, if implemented will only deepen and prolong the recession.

Alan Greenspan as chairman of the Federal Reserve from 1987 through 2006 pursued a cheap dollar and low interest rate policy. To a varying degrees his decision to reduce the Fed funds target to 1 percent, in 2003, where it remained for a year, facilitated the property boom and that the reversal of this policy was the cause of subsequent house price declines is only part of the story. The real culprit in fact was the Federal Government.

Beginning in 1992, congress pushed Fannie Mae and Freddie Mac to increase their purchases of mortgages to low and moderate income borrowers. In 1996 the Department of Housing and Urban Development (HUD) set a target for these types of loans at 42% of their mortgage loan financing. The target increased to 50% in 2000 and 52% in 2005.

For 1996, HUD required that 12% of all mortgages purchased by Fannie and Freddie be affordable loans increasing the target over the years, 20% in 2000, 22% in 2005, and 28% in 2008. Typically these borrowers had incomes of less than 60% of their areas income.

Between 2000 and 2005 Fannie and Freddie bought billions of dollars of sub prime loans, adjustable loans and loans where the borrower had less than 10% down. In fact in order to meet the requirements set by HUD they had to buy billions of dollars of additional sub prime securities for their own portfolios creating a demand for such high risk loans.

In 1997 congress did to the traditional banks what they did to Fannie and Freddie, they passed the Community Reinvesment Act (CRA).

In 1997 Bear Sterns securitized the CRA loans for the first time and since then billions of dollars of loans have been securitized and sold to investors around the world. Initially Fannie, Freddie and the commercial banks were against these risky loans, but when they realized they could make big profits with little risk, greed took over. Teaser loans were offered at extremely low rates and no down payment to low income and risky borrowers. The Feds did their part in 2003 by lowering the federal funds rate to a 40 year low of 1.25%. The end result was to bring down the entire financial system and hurt the very people that both the Clinton and Bush administrations tried to help.

It's Time for Change

If history is any indication, Obama's solution to the problem, higher taxes, and more government regulations will only prolong and deepen the recession.

His equivalent to the Smoot-Hawley Tariff Act is to say he will unilaterally renegotiate NAFTA and other trade agreements imposing human rights and labor restrictions that will certainly result in a trade war.

In a world of instant communications and air travel, his proposal to increase the tax on those who make over $120,000, as well as increasing the tax on capital gain and dividends will cause capital to flee the country.

Hoover established the framework that resulted in the New Deal of Roosevelt. So too is the Bush adminisration facilitating the Obama move to nationalize key industries. The $700 billion stimulas plan effectively nationalized key banking, investment and insurance sectors. Now a second stimulas plan will effectivly take over the American auto industry.

Obama plans to nationalize the heathcare system with his version of Hillary care, 20% of the economy.

There is already talk of the nationalization of the all retirement plans. Under the cover of saving the peoples savings the government will nationalize all retirement plans issuing the equivalent of government bonds. This will have the affect of completing the nationalization of the private sector and solving the trillion dollar national debt problem. The Federal government will now be able to raid the retirement fund as they do to Social Security.

As Obama moves the country towards the European style of government, we can expect a continuation of high unemployment, slow growth and a stagnant economy.