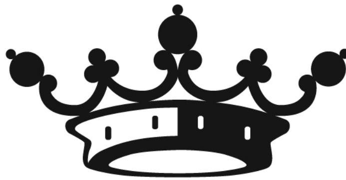
ASPATORE SPECIAL REPORT

Comparisons of the Current Financial Crisis to the Great Depression



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Are We Too Late? The Important Lessons of the Great Depression Revisited

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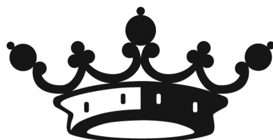

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The Current Conditions

Today's economic conditions for are eerily similar to those of the 1920s and 1930s:

- **Low Consumer Confidence.** Consumer confidence, then as now, is largely driven by news media. Since mid-2006, news reports have been consistently negative concerning the housing bubble. The bubble initially was a regional problem in California, Arizona, and Florida, but when it started to impact national banks, it became a nationwide negative news story. The same type of sentiment took place leading up to October 1929. News reports about a "speculative orgy" on Wall Street were common. Even the Federal Reserve chairman stated that he would be actively slowing the growth of speculative credit. President Hoover gave his public blessing to the task. The public's fear of bad times was directly addressed by Franklin Delano Roosevelt's famous first inaugural speech that Americans had "nothing to fear but fear itself."

- **No Executive Leadership**. In both cases, the U.S. leadership structure featured an unpopular sitting Republican president, viewed by the masses as strongly pro-Wall Street. Most of us accept the tenant that leadership necessarily must lead by example. In the 1930s, many considered President Hoover both incapable and unwilling to deal with the excesses on Wall Street in a proactive manner. Hoover stated, "It is just as important that business keep out of government as that government keep out of business." President Bush faces a similar lack of desire to actively manage the economy—and he has repeated Hoover's mantra that the economy is "fundamentally sound." It is not and it was not. Main Street America bought into it for a short time during Hoover's reign, and for a short time during Bush's last term.

- **Buying On Margin**. Margin buying is the use of borrowed money to acquire stock. It produces leverage because it allows you to control a high-priced asset (a stock) without having to pay the full purchase price. In the 1920s, the government did not control margin buying of stocks. In the current decade, margin buying of

homes was not controlled by the government, yet many of the loans were guaranteed by the government. The subprime market feasted on small or non-existent down payments. The danger of leverage has never changed: in a falling market, losses occur quickly and are magnified.

- **Highly Leveraged and Under-Regulated Investment Vehicles.** Investment trusts, which are similar to closed-end mutual funds, were all the rage with investors in 1929. They often held highly leveraged common stocks, and rarely (if ever) published their portfolios or calculated their net asset values. Hedge funds are all the rage in 2008. They live on the concept of leverage and the use of other people's money to boost performance, but they are even more dangerous because they must make money in falling markets as well as rising markets. Thus, in a falling market they exacerbate the downturn. The downfall of Washington Mutual and Lehman Brothers shows signs of enormous hedge-fund involvement.

- **No Safe Harbor for Investors.** Regulated public utilities provided a safe haven for investors before 1929. Investors relied upon the setting of rates by state regulators—but the bubble burst on that safe haven and utilities were some of the biggest losers in the market. Similarly, one of the first precursors of bad times ahead was the complete collapse of auction-rate securities in early 2008. These investments were marketed to John Q. Public as risk-free equivalents to money-market accounts. Many fixed-income investors are now finding out that there are no risk-free investments.

- **Goldbugs Return.** The private ownership of gold soared in the early years of the Depression. People did not trust the dollar even though it was tied to United States gold reserves. The problem became so severe that President Roosevelt had to outlaw the private ownership of gold bullion because of hoarding. In 2008, the dollar is no longer tied to the gold standard—but the goldbugs have returned en masse. Today, the dollar stands at record lows even as the U.S. Mint has stopped selling gold coins because of the

> exceptionally strong demand for them. Not important on a national scale, goldbug activities indicate that there is a fundamental debasement of our currency in the eyes of our citizens.

Surprisingly, the regulatory structure that led the way to the Depression is very similar to the structure that appears to have caused our ongoing economic meltdown. While the current state and federal governments have thousands of more laws and regulators than were extant during in the 1930s, they have failed to effectively police the stock, real estate, and commodities markets—and there is no legitimate excuse for this failure. By way of contrast, the government in the 1920s had not yet been given the expansive powers that it possesses today. Laissez-faire capitalism was not a dead concept; many Americans accepted the excesses of capitalism as an expected outcome of business ventures. Today, there are almost no legal constraints on what a government can and will legislate regarding business interests. With that expanded power comes a concomitant responsibility to the people to not over-legislate or under-regulate. This is where the government and our legislators have failed in both regards. We have a system of too much legislation, and too little regulation.

In *United States v. Butler*, 297 U.S. 1, 56 S. Ct. 312, 80 L. Ed. 477 (1936), the court ruled that the agricultural poultry processing taxes instituted under Roosevelt's Agricultural Adjustment Act of 1933 were unconstitutional under the Spending Clause of the Constitution. The decision is important because it is the last time the Supreme Court struck down an act of Congress as beyond the authority granted by the Spending Clause. These types of challenges may return, depending upon the structure of the bailout bill, but more likely, the fact that no intervening cases have utilized this reasoning makes it likely that current bailout funding plans will not be struck down in a similar fashion to Roosevelt's New Deal plans. But be forewarned, the Supreme Court is quite conservative on economic policy, just like it was in the 1930s. Expansive Democratic plans for government intervention may not survive constitutional muster.

As one of the cures coming out of the Great Depression, The Glass-Steagall Act, 1933, § 23, 48 Stat. 189-190, prevented commercial banks from owning or participating in investment banking and brokerage actions. The Act worked very well, and resulted in booming investment banking

business. But, as will be explained later, Congress tried to fix what wasn't broken in 1999, and the Act was repealed. This was one of the more significant causes of our current economic problems.

The Commodity Futures Modernization Act of 2000, P.L. 106-554 allowed both credit default swap deals and electronic commodity trading to be outside the constraints of U.S. regulation. This was the straw that broke the camel's back when the housing bubble burst. This Act allowed unchecked speculation to overrun our economy.

The current stalemate in Congress heightens the realization that most of the New Deal concepts were ushered in during the first 100 days of Roosevelt's presidency in 1932. President Roosevelt had momentum arising from his victory; in all likelihood, the political climate in Washington will not allow such a surge for the president-elect in early 2009. Ultimately, almost all of Roosevelt's New Deal was struck down by the very conservative Supreme Court of the mid-30s, and the Supreme Court of 2008 is showing a strong conservative bent as well. The ultimate arbiter of whether any remedial legislation is legal continues to be the Supreme Court. Roosevelt recognized this and tried to change the composition of the court. He also began utilizing executive orders to accomplish his purposes after the electoral surge had subsided. Anticipate that the president-elect in 2009 may have to do the same, since a strongly divided Congress is likely, whether the division is on political or philosophical grounds.

The primary cause of our current problem is real estate lending. Home ownership became part of the American Dream after World War II. A politician that proposed any restriction on home ownership was soon unemployed. But a fundamental shift has occurred in the past ten years. Home ownership went from an attainable dream to an economic right. On top of that, a home became more of an investment rather than an asset—marking a fundamental change from the Great Depression.

The Great Depression was predicated primarily upon stock-market speculation. At a certain level of abstraction, the root causes of the problem are the same—leveraged buying of assets—but the impact is quite different. In 1929, you would lose your job or your bank account. In 2008, you lose your home—and, perhaps, your job in 2009. Having said that, FDIC

insurance is preventing a run on your bank accounts. One of the best lessons of the Great Depression was that failing banks shut down good economic activity as well as bad. Our current government is proactively trying to prevent that from happening, to the potential benefit of all Americans. With every dollar they commit, however, politicians take away a little more consumer confidence in our ability to heal ourselves. Constant demonizing of Wall Street by Roosevelt in the 1930s, and by almost every politician in 2008, will be a drag on any recovery. You do not have to act like Pollyanna to get elected; a sincere focus on regulation—and not *regulations*—is what is needed. Roosevelt poured laws and regulations like cheap wine, yet there is no sound evidence that the Depression was shortened because of any of them.

Solutions and Impacts

Various regulatory solutions were proposed and adopted in the 1920s and 1930s to re-stabilize the market. The affect of some of these solutions linger today, while some have been repealed. The question is whether those solutions would be effective today, and if they should be considered and perhaps applied again.

- **Tax Hikes.** In the early 1920s, economic growth was provided by a series of income tax rate cuts. But when the economy turned down after 1929, Hoover forgot the lesson that less taxation means more money for the private sector. Hoover enacted the largest U.S. import tariff ever in 1930, stifling trade around the world. In 1932, he passed what was at that time the largest tax increase in U.S. history. Both were miserable failures. The lesson should be clear—taxes should be drastically cut during a depression, not raised. Neither political party in 2008 appears to understand that fundamental proposition. It is the private sector that will bring the economy out of a depression, not government spending.

- **Price Controls.** The key to the New Deal was the National Industrial Recovery Act of 1933, which created legally sanctioned cartels in more than 500 industries to restrict output and maintain high prices and wages. Could there be any more un-American view of economic regulation? The price controls did not work then, and

they do not work now. In the Depression, unemployment surged and prices were higher. Thomas Paine had it right, "The government that governs least, governs best," is the proper response to any ideas of price controls, or as is more commonly in fashion today, "excess profits taxes on big oil." Resist the urge; they do not work.

- **Government Regulation of Employment.** The U.S. government became an aggressive regulator of the employment relationship during the Great Depression. Minimum wage rules, the newly created Social Security tax, and compulsory union rights gained a foothold during the 1930s. You may have noticed that we have not gotten rid of any of these ideas, even though the depression ended seventy years ago. Did they help? Absolutely. Should they have continued for seventy years? Maybe. The point is this: When government starts getting involved in the economy, it rarely does so on a temporary basis. So as you ponder the importance of an industry bailout, or two, or ten, remember that you will soon smell like a camel when you let its nose get into the tent.

- **Government Owning Private Mortgages.** As the economy cratered in the 1930s, people lost their homes. This was often also a loss of their livelihood, because a substantial portion of Americans were farmers. Congress established the Home Owners' Loan Corporation (HOLC) in 1933, which acquired refinanced and lowered interest rates on more than 1 million delinquent mortgages. Because there was no secondary market, HOLC held these mortgages for fifteen years, which was unusual because most mortgages were written for five years or less. The HOLC was liquidated in 1951—but this program worked, providing some hope for the financial bailout of today's banking industry.

- **No Joint Commercial Bank/Investment Bank Operations.** The stock market meltdown of 1929 caused a banking meltdown in 1933. A significant part of that latter failure was caused by the overlapping ownership of commercial banks and investment banks. When one went bad (investment banks in 1929), it was only a matter of time before the other went bad (in 1933). The Glass-

> Steagall Act prevents overlapping ownership. This Act worked superbly until it was repealed by a law sponsored by Senator Phil Gramm in 1999. The meltdown in 2008 has been caused, in substantial part, by this repeal.

New Deal solutions invariably involved more regulations, more taxes, and more government involvement. Besides the National Industrial Recovery Act and HOLC, which directly intervened in private industry, the most influential legal solution was the use of the federal government as the nation's employer of last resort.

Most of Roosevelt's programs were against free market principles and they resulted in higher job loss and artificially high prices. (There is no need to make a product if people cannot afford it.) The U.S. government became an employer of last resort. This was the first real seed to the welfare society. Currently, the unemployment level has not risen so high that government employment is seen as a means to an end. But the banking bailout proposals all entail larger, if not gigantic, government bureaucracies.

Additionally, there seems to be little discussion on paying for these programs: deficit spending is now ingrained in our society. But one legal solution did work well: passage of the Glass Steagall Act, which prohibited commercial banks and investment banks from being jointly owned. This created a barrier, in effect a dam that slowed the disintegration of the credit markets during recessions for the next six decades. That law was repealed in 1999.

Time spent on prevention of a recurrence may be more valuable than stopping what is already in place. But one of the first things to do is to suspend the mark-to-market accounting rules related to collateralized security debt, and credit default swaps. The technical insolvency of many financial institutions is directly related to the strict adherence to this rule.

The rule requires that the owner of an asset repeatedly measure its market value and reflect that value on its records. But that rule can cause gross distortions when the holder of the instrument intends to hold the instrument to maturity and can reasonably expect to receive par value for it.

The upside and, in this case, the downside, in the market is essentially irrelevant but, either way, they must be reported as real losses in value. It is not significantly different from the value of your home; as long as you are not going to sell it, why does it matter if it went up 5 percent or down 5 percent? It does not matter to anyone but the tax man. Mark-to-market accounting is very similar. But the following solutions appear historically and economically sound:

1. Significantly cut taxes, across the board, for all persons and entities.
2. Re-enact the Glass-Steagall Act.
3. Close the swaps loophole in the Commodities Futures Modernization Act (CFMA) This so-called "swaps loophole" exempts investment banks from reporting requirements and severe limits on trading positions that are required of other investors.
4. Suspend the market-to-market accounting requirements for financial instruments if the holder intends to keep it until maturity and has a good faith belief that it will be redeemed for par value.
5. Unemployed people need jobs and education. Spend more money on college and job training, and less on corporate bailouts.
6. Gradually privatize Social Security for persons under forty-five years old over the next three years. The influx of money into the stock market will prime the pump to economic recovery just as WWII did.
7. Shrink the federal government, not just slow its growth. It is commanding too many resources. Private companies will lift the economy back where it belongs, not government spending.

If Herbert Hoover was the father of the Great Depression, this economic crash was fathered by former U.S. Senator Phil Gramm. Two laws Gramm sponsored were pivotal in creating our current problem: the repeal of the Glass-Steagall Act and the Commodities Futures Modernization Act, or CFMA. The CFMA allowed electronic traders of commodities (read "oil") to avoid regulation by the Commodities Futures Trading Commission on most trades. This exemption, known as the "Enron Loophole," was inserted into the bill directly by Senator Gramm.

Upon promulgation, the energy markets—and, particularly, oil—quickly became controlled by speculators who had no intention of ever taking

delivery of oil. Every hurricane became a reason to cause market panic. Speculators traded it without limitation, and without scrutiny, even though the oil was often destined for the United States. An accelerator of the summer 2008 subprime mortgage meltdown was the incredible increase in the price of oil caused by the Enron Loophole. Subprime borrowers living on the edge could no longer afford to pay their mortgages and keep up with rising energy costs. By the time legislators moved to close the Enron Loophole in the summer of 2008, the economic damage had already been done. In addition, the CFMA has a loophole that allows large investors to buy and sell oil contracts, known as swap deals, without ever having to take delivery of or use the oil. According to the CFTC, 81 percent of the oil futures being traded in the price run-up of 2008 were in the hands of swap dealers who never intended to accept delivery of the oil. They were in the market for speculation—and this loophole has not been closed.

Moreover, Senator Gramm sponsored a bill that resulted in the repeal of the Glass-Steagall Act in 1999. This attempt at deregulation made it possible for commercial banks to own interests in investment banks. Many of the problems of 2008 have been increased because these interlocking relationships have poisoned the balance sheets of both entities.

This crash has the potential to be another Great Depression if its impact continues to spread throughout the world. It is only when the economies of all of our trading partners go south that the impact will result in soaring unemployment and a shrinking gross domestic product.

The interdependency of global markets was crucial to the Great Depression. The Smoot-Hawley Trade Act made sure that all economies sunk. There was simply no economic partner with the financial might to weather the storm unscathed. Although there are rumblings for a tariff on Chinese goods, they seem to have little political life in them. Additionally, free-trade pacts like NAFTA make it less likely that we will attempt to improve our economic position with shortsighted attempts to construct trade barriers.

The Proactive Attorney

Your role as an attorney will change because this downturn could last years and cost many people their livelihoods. Strategic planning for your clients, particularly in contractually protecting them from bankruptcies and bad debts, will be much more valuable to them. In addition, you may be called upon to locate capital and investors for your clients. And you should not forget, your firm is a business that is not immune to this large-scale debacle. Put growth plans on hold and limit your debt until this settles down. You might also consider developing a working knowledge of government contracting. The only entity certain to grow over the next few years will be the U.S. government.

The role of counselor has change drastically since the Great Depression. There will be more and more regulations, and that inevitably leads to more counseling. Beating your client's competition through regulation and lobbying has become a staple of many good counselors, not just on the federal level. State and local contracts will flow from this swinging pendulum of over-regulation. Clients that can be certified for historically underutilized business contracting will blossom. Position yourself to be a proactive resource, not just a reactive cog in the wheel. Most of all, remember that history does repeat itself. Lawyers who thrived through the Great Depression often had clients or specialists that dealt with the government. The government's influence on the economy grows during hard times. Understand that your clients must also survive, so attention to collections, contract risk shifting, and bankruptcy law could be very fruitful. And do not forget about the onslaught of wrongful termination of employment cases that will now be based upon discrimination claims. There are areas that will expand, but you must survive as a business to exploit them.

Bruce K. Packard focuses his practice in business litigation, securities litigation, and employment litigation. He has the unique background of having spent approximately half of his career primarily as a defense lawyer and the other half primarily as a plaintiff's lawyer, with a stint as in-house counsel as well. He is, first and foremost, a trial lawyer who enjoys the battle that high-stakes litigation entails.

He was admitted to the State Bar of Texas in 1985 and is admitted to practice before the U.S. District Courts in the Northern, Southern, Eastern and Western Districts of Texas, as well as the Fifth Circuit.

After receiving his bachelor's degree cum laude from Butler University, he received his law degree from the University of Michigan in 1984.

He regularly publishes articles on business litigation and risk assessment, and is a frequent speaker on legal issues of significance.

Dedication: *This report is dedicated to my grandparents, Frank and Elizabeth Morse, who lived through the Great Depression and passed on many lessons learned from that era.*

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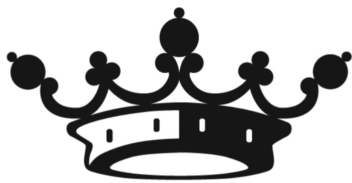

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