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From Economic Crises of Yore, There's Hope -- and Harbingers

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With stocks sagging, public anger at corporations rising and fear of war growing, what's in store for the economy? Is the U.S. in for a replay of the 1930s, when the economy snapped after a stock-market plunge? Or is it more like the 1960s, when war unleashed inflation? How about the 1970s, when oil shocks battered the economy?

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No single example fits today's combination of circumstances. But past epochs yield insights for today. The railroad boom and bust of the 1870s offers the possibility of a happy ending to the telecom glut. The bursting of that earlier financial bubble was followed by a new era of growth. The 1920s, meanwhile, are a cautionary tale of how policy-maker overconfidence can strangle an economy. The 1960s teach the risks of cutting taxes and fighting wars simultaneously. The 1970s suggest that productivity counts for more than headline-grabbing oil embargoes.

"The economy is constantly feeding us surprises," says former Federal Reserve Vice Chairman Alan Blinder. "Economists get ideas of what questions to ask by looking at history."

The Gilded Age

In the early 1870s, the railroad drove economic expansion and created glittering wealth much as telecom and Internet investment did in the 1990s. Intercontinental railroads turned the U.S. into a unified market from coast to coast. Retailers expanded to supply immigrants building the tracks. Land values soared along the routes. Cargo that had taken weeks to travel by boat and wagon moved in days, a speed-up as revolutionary as the one that networked computers brought in the 1990s. Indeed, telecom companies lifted the word "trunk lines" from their railroad forebears.

The railroad era was riddled with corruption and miscalculation. Rail barons worked political connections to obtain federal land grants. Speculators grew rich and binged on credit. "I wasn't worth two cents two years ago," a character in Mark Twain's "The Gilded Age" remarks. "Now I owe $2 million."

An 1872 scandal gave an early warning of trouble. Owners of the Union Pacific Railroad set up a subsidiary, Credit Mobilier, ostensibly to build a line west from Omaha. Its larger purpose was to siphon money through overcharges. Profits went to Union Pacific executives and prominent lawmakers. Rail executives were grilled in Congress and some lawmakers were censured.

A year later, everything collapsed. An overextended railroad financier, Jay Cooke, declared bankruptcy, setting off a panic on Wall Street. The New York Stock Exchange closed for 10 days. A fifth of the railroads filed for bankruptcy. The economy fell into deep recession. Rail stocks sank by a third between the end of 1873 and the middle of 1877. But then the railroads once again powered an expansion, this one so explosive that journalists for the first time used the word "boom" to describe the economy, says Vanderbilt University economic historian Jeremy Atack. By 1880, technological gains, including mightier locomotives and better signal systems, were reducing shipping costs for manufacturers and department stores. The 1881 arrival of refrigerated rail cars helped create a national meatpacking industry. Montgomery Ward turned to railroads to deliver catalogs and fill orders. As demand surged, mothballed railroads came back into service, and more were built. Railroad stocks revived.

Today's bankrupt optical-fiber networks are as fallow as some railroad tracks were in the 1870s. But the networks still have the potential to be the backbone of a high-speed global communications system for years to come. "Over the long haul, the predominant costs in [telecommunications systems] are acquiring rights of way," says Dale Hatfield, a former chief of engineering at the Federal Communications Commission. Those costs have already been paid.

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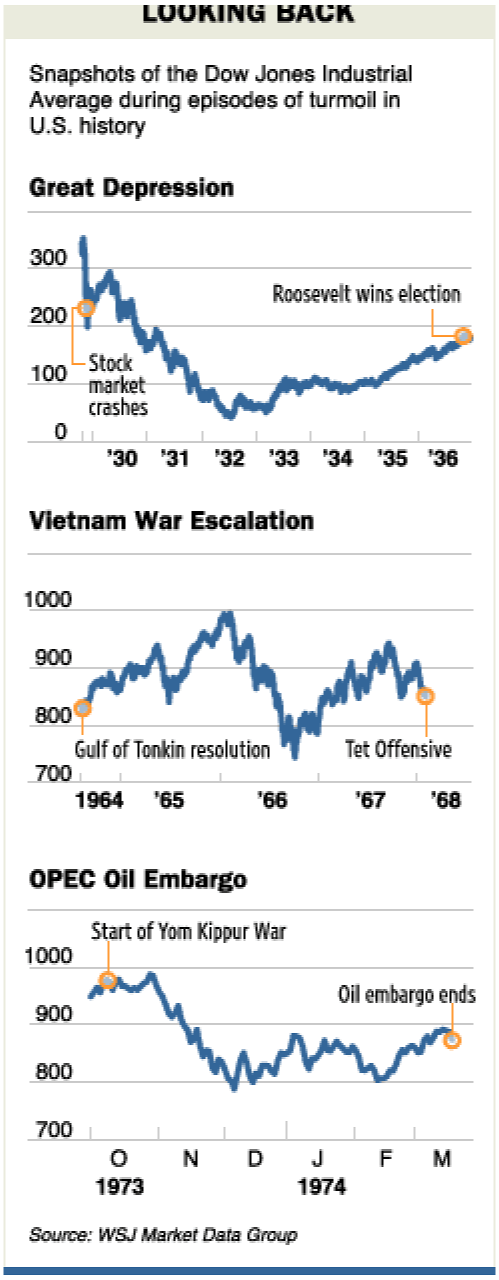
What's missing today, as with the railroads in the 1870s, is sufficient demand. But demand could rise with changes in e-commerce, medical imaging, genetic information, entertainment or other technologies that would require super-fast communications.

So one lesson from railroads' tumultuous history is a positive one: The bursting of a technology-powered financial bubble can obscure the economic power of the underlying technology. A nearly worthless asset today can become the mainstay of an economy tomorrow.

The Great Crash

Over two days in late October 1929, the Dow Jones Industrial Average plunged 24.6%. Bad spells were hardly rare on Wall Street, but this one was followed by the Great Depression, which eventually put a quarter of Americans out of work.



Economists today largely blame the Federal Reserve for worsening the downturn by raising interest rates instead of cutting them. But Fed officials at the time thought they were acting wisely. In today's lingo, they were trying to get ahead of the curve, and the Hoover White House was encouraging them.

In 1928, the Fed had raised interest rates to prick what it saw as a speculative bubble. The subsequent stock drop and economic slowing led the Fed to believe mistakenly that it had prevented an even worse outcome. After the stock-market crash, Fed officials made another misstep. The key to economic stability, they thought, was preserving the gold standard. So to prevent a rush of investors demanding gold for their dollars, they raised interest rates in 1931 and 1932. The increases wound up strangling the economy.

Protecting gold seemed like an obvious move to policy makers then. "Gold was moral, principled and civilized; managed money was the opposite," write economists Barry Eichengreen of the University of California at Berkeley and Peter Temin of the Massachusetts Institute of Technology.

Sixty years later, the Bank of Japan made a similar calculation, pricking a financial bubble and then resisting calls to cut interest rates for fear of producing a new speculative binge. Japan's economy has stagnated for more than a decade.

Alan Greenspan, however, learned from his Fed predecessors. In October 1987, after stocks plunged 22.6% in a day, his Fed informed banks it would provide as much credit as needed to keep the system going. And in 1996, although Mr. Greenspan warned of "irrational exuberance," he didn't deflate the stock market through interest-rate increases. After the market bubble burst on its own, the Fed responded by repeatedly lowering interest rates.

Yet a larger lesson of the 1920s is that policy makers aren't as smart or all-knowing as the rest of us may hope, or as they sometimes pretend. So, what mistakes might the Greenspan Fed be making now that will be recognized only later? Will Mr. Greenspan's comforting words that rising housing prices aren't a bubble prove faulty? Is the Fed fueling a new round of inflation by keeping rates too low now? Or, on the contrary, might it be underestimating the economy's continuing weakness and not cutting rates enough?

The Populist '30s

In 1935, with the economy in turmoil, Wall Street in disrepute and the Supreme Court hostile to his programs, Franklin D. Roosevelt turned sharply left. Attacking "economic royalists," he endorsed a soak-the-rich plan to raise taxes on the wealthy, a bill to protect workers' right to organize and legislation to break up utility holding companies.

Today's business scandals have also produced strong anticorporate sentiment. The president and the Treasury secretary have denounced wayward executives. Congress has toughened criminal penalties on executives who mislead shareholders. About 71% of Americans think "more should be done" to crack down on corporate fraud, according to a September Wall Street Journal/NBC news poll.

But to translate such sentiments into political change requires effective and charismatic politicians. FDR was prodded to action by challenges from Louisiana Sen. Huey Long and a fiery radio priest known as Father Coughlin, who warned his millions of listeners about "predatory capitalism." Historian Alan Brinkley says a secret poll the Democrats took showed Sen. Long might win up to 10% of the presidential vote if he ran as a third-party candidate in 1936, possibly handing the White House to the Republicans. Sen. Long was scoring points with a "Share Our Wealth" plan that would limit individual fortunes to about $4 million and take the rest in taxes.

Sen. Long was assassinated in September 1935. But by then, FDR had proposed his own wealth tax and other measures to pre-empt the challenge. He won in a landslide the next year.

Today, no national leader is pressing an anticorporate crusade that might force the political establishment to embrace FDR-style changes. Ralph Nader's Green Party has only 225,000 members. The Reform Party started by Ross Perot is riven by factionalism. Antiglobalization protesters haven't been able to agree on a specific agenda for change.

The Democratic Party tries to tap into the discontent but also wants to show it is pro-growth. Liberal Sen. Paul Wellstone of Minnesota, in a re-election struggle, had his attacks on corporate misbehavior turned against him when a GOP leader accused him of being soft on the failings of unions. "People are upset with business, but do they think the country is run by big companies? No, they don't," says Ruy Teixeira, a liberal Democratic pollster.

Much of the public is outraged over the behavior of some corporations, accountants and executives. But without a captivating populist, the anger may not translate into deep economic changes.

The Vietnam Deficits

In the 1960s, the U.S. economy was as healthy as it had ever been. Inflation was tame, unemployment was quiescent and incomes were rising. In a 1965 poem, John Updike poked fun at growing American abundance:

I drive my car to the supermarket,
the way I take is superhigh,
superlot is where I park it,
and Super Suds are what I buy.

But by the end of the decade, inflation was darkening the picture. Growing budget deficits, caused by the Vietnam War's unexpectedly high cost, were largely at fault.

Last month, with the U.S. facing possible war with Iraq, President Bush warned of the Vietnam parallels. "We cannot go down the path of soaring budget deficits," he said.

Like Mr. Bush, Lyndon B. Johnson came into office convinced of the power of a tax cut. In LBJ's case, it was the Kennedy tax cut, which was passed after Mr. Johnson succeeded JFK and spurred the economy as its architects promised. But as Vietnam spending pushed the economy beyond its limits, Mr. Johnson's advisers urged tax increases to slow the pace of economic growth. He resisted, worried that tax boosts would undermine support for his Great Society programs.

A financial crisis finally forced him to act, says University of Missouri historian Robert Collins. Fearing a U.S. devaluation, foreign governments began demanding gold for dollars. Speculation was so intense the U.S.

considered airlifting gold from Fort Knox to New York, to reassure governments they would get gold if they demanded it. Communist China's news agency announced that "the capitalist system has in fact collapsed."

President Johnson eventually agreed to tax increases and spending cuts. They came too late to curb inflation. Just 1.3% in the first half of the 1960s, inflation hit 5.5% in 1969. Despite the wage-price controls Richard Nixon imposed in the early 1970s, inflation was at double digits at the end of the 1970s. It took a series of Fed interest-rate increases and the worst recession since the Depression to break inflation's back.

Today deficits are again rising, and war spending is threatening to widen them. An Iraq war could cost $100 billion to $200 billion the year it happened, says White House economist Lawrence Lindsey, although others offer lower estimates. Meanwhile, Mr. Bush is as committed to phasing in the rest of his $1.3 trillion tax cut as Mr. Johnson was to avoiding a tax boost 35 years ago.

The risk this time isn't so much inflation as a growing debt burden and dearth of savings that would make it hard to pay for baby boomers' retirement and medical care. That demographic reality may be the most significant force pushing on President Bush to raise taxes or defer planned tax cuts.

A lesson from the Vietnam era -- and from the 1980s as well -- is that Congress isn't likely to reduce spending sufficiently to cover deficits that are rising steeply. If deficits keep growing, so does the pressure to raise taxes.

Stagnation in the '70s

The U.S. economy was battered twice in the 1970s by violent events in the Middle East. The 1973 Arab-Israeli war led to an oil embargo of the U.S. by the Organization of Petroleum Exporting Countries and a quadrupling of oil prices. Then in 1979, oil prices doubled after Iranians overthrew the Shah and took Americans hostage. Both times, the oil shocks spurred inflation in the U.S. and dumped its economy into recession. For the decade, stock prices declined about 40%, taking inflation into account, say researchers Ibbotson Associates in Chicago.

Though neither of the oil crises packed the shock of Sept. 11, they were major blows to confidence, making Americans wonder if the nation faced still more traumas. The future seemed so unsure that in 1979, President Carter warned of a national sense of "paralysis and stagnation and drift."

But one reason the oil shocks were so damaging was that they hit an economy that already faced another malady: a decline in the growth of labor productivity. Rising productivity, or output for each hour of work, permits employers to pay people more without spurring inflation. And productivity had been rising rapidly from the end of World War II until about the time of the first oil shock.

It is now clear that for two decades starting in 1973, productivity flattened out. Just why is still debated. Economists initially blamed the oil shocks, but productivity also lagged when oil prices came back down after each oil-price jump.

Now stocks are again doing badly and economic growth is sluggish. The economy could take another wallop if a war with Iraq sharply cut the flow of Middle East oil or another major terrorist attack undermined consumer and business confidence.

But the productivity situation is different today than in the 1970s. Since 1996, productivity has been rising at brisk levels similar to that of the 1960s. Once again, economists aren't altogether sure of the reason, but the consequences are clear: In 2002, hourly earnings, adjusted for inflation, have grown nearly as fast as in the mid-1960s.

This strength in productivity makes the economy more resilient to unexpected shocks. Says Mr. Greenspan: "With the growth of productivity well maintained and inflation pressures largely absent, the foundation for economic expansion has been laid."

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