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An Analysis of American Government Intervention During Economic Turmoil

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ABSTRACT

This paper argues that the most severe economic turmoil in the United States can be attributed to government intervention. Through analyzing three detrimental economic collapses from different periods including the Great Depression, the 1987 stock market crash, and the 2008 financial crisis, governments' economic policies have triggered and exacerbated these crashes. Examining the transition away from free market principles, the United States' current economic approach that constructs a need for governmental oversight has led to many unintended consequences to an extreme degree. Governmental actions that attempt to mitigate risk and stabilize the market have repeatedly instigated further instability and speculation throughout the economy.

As the Austrian-American economist and historian Ludwig von Mises once said, "Every government intervention creates unintended consequences, which leads to calls for further government interventions." The secret behind the United States' largest economic turbulences can be attributed to the fiscal policies the government has enacted which influence and distort American financial systems. As fiscal policy can be defined by government spending and tax policies' influence on economic conditions, the government did not always retain complete control over the economy which dates back to the Laissez-faire policies of the mid-1700s. The Laissez-faire policies support free-market capitalism whose principles state that economic success is restrained through government intervention. This financial system established on the policies of no taxes, regulations, or tariffs allowed for a functioning and booming economy throughout the 18th and 19th centuries. As a result of the increasing economic industrial growth, the U.S. economy yielded to Keynesian economics which functioned through active government policies that managed aggregate demand to support the economy. Although active government intervention was intended to strengthen the U.S. economy, the desired state of equilibrium for the economy was only prevented by Keynesian Economics which contributed to economic downturns. Governmental actions have significantly amplified the unstable stock market system, which has augmented risk and caused devastating panic throughout the American population. The government's economic policies for the stock market are responsible for the most severe recessions in United States history including the Great Depression, the 1987 stock market crash, and the 2008 Financial Crisis.

As bank failures and panics contributed to a speculative market in the 1920s, governmental actions from the Federal Reserve and President Hoover initiated and escalated into the Great Depression. The stock market's bull run that fed into an investing speculative bubble caused the general public to want to chip into this feasible scheme of making quick money. Through many pouring loans into invested stocks, Edmund Gale's political cartoon "Getting Ahead of the Band Wagon," depicts the greedy and continuous cycle of investors allocating speculative credit into stocks. The Federal Reserve, in charge of regulating the United States banks, attempted to curb the stock market speculation to restrict volatile economic activity. The Federal Reserve tried to counteract the speculation and almost minimize public gains by "raising interest rates in hopes of slowing the rapid rise in stock prices." The Federal Reserve's overreaction in trying to preserve a tight monetary policy and the gold standard equated to steep declines in both production and prices. Within the labor industry, in particular, farmers who relied upon product sales to support their lifestyles, stumbled into bankruptcy after the Fed's induced deflation drowned their sources of income. Other prominent causes including the absence of bank loan liquidations and overinflated stock shares caused the stock market's bubble to burst, plummeting shareholders' value and causing investor panic. The infamous Black Thursday on October 24, 1929, caused panic selling to have a devastating effect spiraling the economy into a horrifying collapse known as the Great Depression. Although the severity of the Great Depression had already been initiated, the government and President Hoover enacted protectionist trade policies, which escalated the crash to a more distressing state. In 1930, President Hoover executed the Smoot-Hawley Tariff Act which stated, "If a perfect tariff bill were enacted today, the increased rapidity of economic change and the constant shifting of our relations to industries abroad will create a continuous stream of items which would work hardship upon some segment of the American people except for the provision of this relief." The focus of the Smoot-Hawley Tariff was to protect the American economy from foreign trade competition which only backfired in aggravating the international depression and foreign tensions. As the Smoot-Hawley Tariff marked up the cost of imports by around 20%, other countries established their own tariffs which caused international trade to crash. This disaster further exacerbated the effects of the Great Depression signifying that the ideal tariff bill could not be constructed without the means of flexibility in adapting to the shifting state of American trade relations and the U.S. economy. The governmental policies enacted by the Federal Reserve and President Hoover triggered the devastating consequences of the Great Depression on the American population.

Although the 1987 stock market crash can be attributed to various underlying reasons, the governmental actions of executing the Plaza Accord in 1985 and the Tax Reform Act of 1986 had a significant impact in causing the volatile market to plunge downwards. Throughout the first three-quarters of 1987 economic growth came to a halt while inflation levels continued to increase. An investor panic occurred as many wanted to liquidate their positions, and the Dow Jones Industrial Average reached record declines dropping almost 23% in one trading session. On September 22, 1985, at the Plaza Hotel located in New York, officials from the U.S. and other G-5 countries established the Plaza Accord which was intended to reduce the trade deficit between international economic imbalances. In "From Neglect to Activism: American Politics and the 1985 Plaza Accord," C. Randall Henning, and I. M. Destler claim, "Domestic politics, driven by dismal American trade performance, was at the heart of the decision to depreciate the dollar." As the U.S. dollar's value climbed 44% against other foreign currencies in 5 years prior to 1985, a foreign exchange intervention agreed to bring down the value of the dollar. The G-5's action of deflating the dollar led to a loss of credibility and confidence in the U.S. markets from the public's standpoint. Investor anxieties that cycled into a panic contributed to the market instability ultimately funneling into the 1987 stock market crash. Although these changes in monetary policies had a direct correlation with the stock market's downfall, the government's implementation of tax policies contained a more indirect linkage to the 1987 crisis. President Reagan's signing of the Tax Reform Act of 1986 influenced market conditions tailored to the real estate industry by minimizing real estate investment benefits. The harmful effects of the Tax Reform Act of 1986 include extending real estate depreciation schedules and "introducing limitations to the passive loss deduction, which previously encouraged some tax-motivated construction projects. By lowering personal income tax rates and expanding the standard deduction, it also reduced the benefits of the mortgage interest deduction, and it raised capital gains taxes on real estate sales." As the Act reduced profitability margins from real estate investments by eliminating specific incentives and deductions, many began dumping and abandoning their real estate projects. This reform harmed the real estate market and contributed to the savings and loan (S&L) crisis which caused many banks to suffer. Investors' fear stemmed from the S&L crisis, which was ultimately linked to the stock market's downturn, which spiraled down in response to the panic cycle. The government's economic policies of the Plaza Accord and Tax Reform Act of 1986 served as root causes of the deterioration of the U.S. economy channeling into the 1987 Stock Market crash.

The active government policies of instituting the repeal of the Glass-Steagall Act in 1999 and implementing the Commodity Futures Modernization Act in 2000 are essential factors of the 2008 Financial Crisis. The collapse of the stock market topped by the decline in U.S. housing prices triggered the risky practices that led to the 2008 Financial Crisis. The housing market's slump was attributed to the subprime mortgage crisis that lasted for around two years and was driven by mortgage lenders who easily gave out mortgages to unworthy borrowers. The unstable housing system allowed for aggressive mortgage lenders to maximize gains by lending mortgages to borrowers with low incomes or a poor credit history. As the adjustable interest rates caused borrowers to put themselves into unaffordable financial situations, borrowers were buried in housing mortgage debt. The rise in speculative activities occurred due to the repeal of the Glass-Steagall Act in which the unstable financial system allowed many financial institutions to engage in riskier practices. As the repeal allowed for the absence of governmental oversight, the housing market was only building up speculation and risk while awaiting an awful collapse. The purpose of the Glass Steagall legislation was "to separate the savings of depositors from the more risky operations of the financial markets. Banks started to get involved in financial speculation, not only as a lender to speculators, but speculating with their own reserves." As the repeal of the Glass-Steagall Act abandoned the separation between commercial and investment banking, this deregulated financial system inflated home prices and swindled borrowers to a greater extent. The cycle of borrowers taking out larger mortgages increased as a result of the housing market's increased return, but once prices began dipping, borrowers could not afford to refinance their homes. As foreclosures became a common sight, the destroyed American economy entered a crisis state leading to a surge in unemployment rates. The financial institutions in the housing market which experienced minimal oversight began the use of credit default swaps which contained no safeguards within the market regulation. The lenders that used these financial instruments were unaware of the hazardous consequences that credit default swaps posed to the financial system as a whole. The Commodity Futures Modernization Act of 2000 which enabled this risky financial instrument states, "Unregulated derivatives not only helped to conceal such exposures by means of credit default swaps, but also helped to magnify them through collateralized debt obligations." The lack of regulation surrounding credit default swaps caused by the Commodity Futures Modernization Act of 2000 threatened the rupture of the whole financial system due to a chain reaction. As the credit default swaps allowed for the interconnectedness between various financial institutions, the subprime mortgage crisis caused by the housing bubble constituted systemic risk and magnified the impact of this governmental failure. The 2008 Financial Crisis stemmed from a chain reaction that occurred due to the government's repeal of the Glass Steagall Act and the Commodity Futures Modernization Act.

The government's active intervention in implementing policies to support the U.S. financial system has directly caused the most severe recessions in U.S. history including the Great Depression, the 1987 stock market crash, and the 2008 Financial Crisis. As three of the largest economic crashes have been caused by extreme speculation and market manipulation, this has led to the increase in governmental oversight to impose proper regulations to manage the financial systems risks. Recent crashes in today's stock market, for example, the Covid-19 pandemic allowed for governmental policies to enforce stabilization programs and monetary policy changes to minimize the degree of the economic downfall.

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