the reading room
the great crash 1929

By John Kenneth Galbraith
Pelican Books
223 pages

review rating

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John Kenneth Galbraith (JKG) is possibly the most well know if not most eminent economist since Keynes – although he is said by some not to be "main stream" Born in 1908 he enjoyed a spectacular academic career at the universities of: Ontario (undergraduate); UCLA (Ph.D); Harvard (Professor of Economics); Princeton and Cambridge, England – Fellow of Trinity College. He was closely associated with the Democratic Party and held several senior advisory roles to government (esp. in wartime) and posts – eg, American Ambassador to India 1961-3. He was a prolific author and commentator, and through an incredibly high level of articulation enjoyed a reputation as an effective communicator to the lay observer.

This book is rated ten for two reasons: it covers the most important economic event of modern history; and it is written with masterful prose and lucidity seldom found in modern texts. It is amusing, insightful, hard hitting and holds enduring relevance. Why relevant to today? Because, as JKG observes: "As a protection against illusion or insanity, memory is far better than law… For protecting people from the cupidity of others and their own, history is highly utilitarian." As the All Ordinaries Index has marched through 4,000, and the words "bull market" appear in the press with greater frequency, the timing is propitious to review this book which addresses the most important issue for all investors: avoidance of near total loss of capital. I first read this book in 1987 after the "Crash" of that year (really a bad blip), when my Mother sent it to me from England. It should probably be read every decade, at the least. US investors could have read it with gratitude in 1999.

The two events
In order to appreciate both: the magnitude of the task facing JKG when he wrote this work in 1954, and the gravity of the subject matter, the reader could do worse than initially skim the opening paragraph of Chapter ten, where JKG outlines what happened in the Great Depression. It lasted for some ten years, and by 1933 GNP was nearly a third less than in 1929, and it did not recover to 1929 volume levels until 1937 – and did not recover to 1929 dollar levels until 1941 – yes, 12 years of recovery! Note, in current discussion of 3% annual "growth" (eg, for calendar 2005), that one third contraction of the economy is the modern equivalent of eleven years of growth, ignoring the impact of compounding. Unemployment during these years hovered around 25% and only recovered to 20% by 1938.

The book is mostly committed to the Great Crash and events leading to it, and then turns to the aftermath and what JKG reasons – with qualification – as being the likely causal links between the two events: the Crash and the Great Depression. In chapters dealing with the aftermath and "Cause and Consequence" there is no dogmatic assertion that the Crash caused the Depression, but there is a clear analysis of the matters that link the two events and the reader is left in little doubt that, but for the Crash (or perhaps, more correctly, the market speculation that made the Crash inevitable, at some point) the Great Depression would not have occurred. As amply explained by JKG, the 1929 Crash was a truly tumultuous event that demolished investment returns, wiped out capital/savings, caused widespread misery, and pervaded the psyche of US investors (and those in many other countries) for decades after. No investor should ever forget it.

During his final writings for the book, JKG was invited to testify before a Congressional Committee in 1955, when the market was on it's merry way again, and he was questioned closely on his then views on the level of the market. He took his manuscript with him and referred to sections of it, which aroused some interest in the press. Then came the abusive phone calls and death threats for JKG "destroying their dreams" – which only confirmed one key observation of the book, which in modern finance parlance would fall into the pot of "behavioural finance". The book initially received an underwhelming reception, or as JKG put it "the early market was very orderly". In the midst of this, he entered a favourite bookshop and explained to the proprietor: "I seem to remember a lot of recent discussion about a book – I forget the name of the author, maybe Galbraith – but I think it was called The Great Crash." She replied, "That's not a title you could sell in an airport." Not everyone will wish to hear the messages in this invaluable volume – but avoid them at your peril.

Laying the foundations
JKG starts by outlining the scenario in 1928/9 and most importantly the mood of the day – which mostly emanated from Wall Street. Many people then did very foolish things, and the greater the reputation for omniscience, the more serene the previous idiocy.

He makes the point that no one person, house or institution was responsible for the lunacy – it was simply the result of free choice exercised by thousands of individuals in the crowd. They were not led to the slaughter, rather "They were impelled to it by the seminal lunacy which has always seized people who are seized in turn with the notion that they can become very rich."

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There is a broad outline of the economic conditions in early 1929, which he revisits in "The Aftermath" when addressing causation. Suffice to say that they were fairly healthy and unexceptional – although small cracks were starting to appear. In 1929 auto production stood at 5.4m vehicles, which compared favourably with the 5.7m in the opulent year of 1953. However, against this relatively benign backdrop, dark speculative forces were at large, both in property and equities. One Charles Ponzi was developing and selling a subdivision "near Jacksonville" which was in fact 65 miles from the city!

"Until the beginning of 1928, even a man of conservative mind could believe that the prices of common stock were catching up with the increase in corporation earnings, the prospect for further increases, the peace and tranquillity of the times and the certainty that the Administration, then firmly in power in Washington, would take no more than necessary of any earnings in taxes." These foundations were the rock-bed for, as JKG puts it, ubiquitous "incantation" by the great men of finance who expressed faith in the prosperity of the future – eg, by Mr Mellon (of Mellon Bank). JKG contends that no-one knows the economic future, and that these incantations were not forecasts. Rather, Mr Mellon "was participating in a ritual which, in our society, is thought to be of great value for influencing the course of the business cycle. By affirming solemnly that prosperity will continue, it is believed that, one can help insure that prosperity will in fact continue. Especially among businessmen the faith in the efficiency of such incantation is very great."

As these incantations flourished, the pricing of securities gradually parted from reality: yields regularly ranged from nothing to one or two per cent, whereas interest on margin loans that supported the holding was often at 8, 10 or more per cent – in January 1929 the rediscount call rate was only 5%, but with added loan/credit margin speculators were paying up to 12% for broker margin facilities by the autumn of 1929. Thus, "the speculator was willing to pay to divest himself of all the usufructs of security ownership except the chance for capital gains." There is considerable analysis of the mounting leverage in the market, through margin facilities – even corporates were lending excess cash into the market through margin loans to speculators. The US dollar was strong and funds flooded into Wall Street from offshore to feed the demand for leverage.

It is emphasized that this speculation was not founded on the crazy investment ideas of the South Sea Bubble, but was mostly linked to real corporate earnings. Pricing and turnover just got completely disconnected from reality. But, as intimated by the Congressional experience cited above, things were difficult even for those of conservative conscience who could see storm clouds gathering. As the market continued to race into 1929 some did say that "something had to be done", but for these people: "every proposal to act raised the same intractable problem. The consequences of successful action seemed almost as terrible as the consequences of inaction, and they could be more horrible for those who took the action." Shades of "irrational exuberance" from Dr Greenspan, and the tightrope balancing act of the Federal Reserve ever since?

JKG covers: money supply in 1929; inaction/silence of the Federal Reserve and other bodies; margin loan finance from non-bank sources; first market cracks in March 1929 and call money reaching 20%; the role of Charles E. Mitchell (Chairman of National City Bank, and from January 1929 a director of the Federal Reserve Bank of New York); the August 1929 raising of the rediscount rate to 6%; and then, in chapter IV, "In Goldman, Sachs We Trust" the advent of the investment trust. These trusts grew in fact from the English experience, from whence they originated. JKG provides a revealing exposition of how these trusts developed in the US, for sound reasons, but then introduced leverage and fed upon the speculative frenzy of the day. Further, the trusts (often listed and more like our LICs, than current day mutual funds) invested in each other, and the end result was often cascading leverage on leverage – times over.

These trusts sometimes traded at a significant premium, representing the "value an admiring community placed on professional financial knowledge, skill and manipulative ability", the latter being prevalent in the market due to weak trading rules. Thus, "pools" were often used to ramp stock. This was financial engineering on a grand scale, and holds many lessons for today. It tempted the respectable house of Goldman's into the game, which floated large investment trusts with complicated structures: Shenandoah and Blue Ridge. JKG observes that "it is difficult not to marvel at the imagination of this gargantuan insanity. If there must be madness something may be said for having it on a heroic scale." He quotes with chilling brevity testimony given by Mr Sachs before the Committee of the US Senate in 1932: Goldman's sold 90% of the Goldman Sachs Trading Corporation to the public at 104 "that is the old stock price … the stock was split two for one." "And what is the price of the stock now?" Mr Sachs: "Approximately 1 ¾". In later chapters there is an excellent explanation of how these trusts traded down – and often, out.

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In the "Twilight of Illusion" JKG takes us through the nerve racking days leading to the onset of the Crash: how prophets of doom were pilloried; the immortal assessment of Professor Irving Fischer of Yale (later of Fischer and Black fame), that "stock prices have reached what looks like a permanently high plateau"; the completely erroneous predictions of the Harvard Economic Society (later disbanded after complete discrediting, when the professors ceased forecasting and again donned their "accustomed garb of humility"); the wise (ignored) cautious counsel of Paul Warburg; how market engagement was limited to the wealthy, quite unlike today; and finally New York Stock Exchange turnover levels and the end of the bull market on 3 September 1929.

On the last day of August 1929 the Times industrial index stood at 449 points. By July 1932 it would reach 58 - a fall of 87%. Many "staples" or blue chips would lose 90% of their value in the three years to come. Although it is not explicitly discussed in the book, it seems quite likely that stock valuations may have initially overshot on the downside in 1929/30 (ie, to undervaluation), but as the economy contracted, valuations may have become more fundamentally aligned with the dreadful earnings outlook in the early days of the Great Depression.

By page 111 the reader comes to the Crash, and will not be able to put this book down. The excitement, fear and loathing, the unravelling of dreams and reputations are vividly brought to life. And, unlike 1987 (for those who can remember), there was not one great precipitous fall, but days, weeks, months and years of endless turmoil and stock losses. JKG recounts this with great authority and numerous foot-noted references. His exposition contains a detailed account of the sad and seemingly pathetic attempts to support the market and of the constant recantations that the economy and the market were **"fundamentally sound."** From Presidents, from senior bankers, from economists, from the Exchange – from just about anyone with any vestige of remaining credibility, the reassuring clarion cry was to be heard. These calls followed the market all the way down through 1932, until, by force of total loss of credibility or plain despair, the recantations ceased. Confidence, it is explained, did not disintegrate at once, and we are taken through the vain efforts that were made to stem the tide. JKG observes that, when confidence did start to crack, it could have been that the "inherently unstable equilibrium was shattered simply by a spontaneous decision to get out." By October 1929 real panic had set in, and "often there were no buyers, and only after wide vertical declines could anyone be induced to bid" – and this caused the (again, vain) attempts to fill the "air holes" with organised banker support.

There is analysis of the unwinding of leverage, and the contribution of stop-loss orders, which tripped more securities into the market – this occurred again in 1987 and has resulted in some circuit breakers for program trading on the NYSE.

In "Things Become More Serious" JKG emphasises that the singular feature of the Great Crash of 1929 "was that the worst continued to worsen." He takes us through the agonising decision of the Exchange on whether to close – not only to stop the haemorrhaging, but to allow the poor brokers a respite from exhaustion. The tape was often hours late (ie, behind trading) and some clients did not know that they were ruined until hours after the close of the market. Broker trading mistakes were occurring all the time. The Rockefeller's announced the bottom and bought in – only to see the base fall away from under their feet. Many investment trusts resorted to buying back their own stock (when men, knowingly, defrauded themselves), with some "buy-back" lessons for today.

In the final chapters we are treated to an analysis of the onset of the Great Depression, and, as noted above, the causal links to the Crash. This is a sobering tale replete with socio economic consequences of the thirties and of the political (eg, witch hunt for culprits) and regulatory ineptitude of the day. The storm has blown through for JKG's purposes, and there are other works which deal in more detail with the Depression. JKG concludes by isolating "five weaknesses that seem to have an especially intimate bearing upon the ensuing disaster." This analysis, completed in 1955, still has relevance today, and there are lessons to be drawn from these valuable pages.

The last lesson

In the final page JKG alerts us, again, to the lesson that no investor should ever forget. He outlines how wisdom could prevail in the future and of how it will be possible for things to be different, the next time. But then he opines:

"As noted, all this might logically be expected. It will not come to pass. This is not because the instinct for self-preservation in Wall Street is poorly developed. On the contrary, it is probably normal and may be above. But now, as throughout history, financial capacity and political perspicacity are inversely correlated. Long-run salvation by men of business has never been highly regarded if it means disturbance of orderly life and convenience in the present. So inaction will be advocated in the present even though it means deep trouble in the future. Here, at least equally with communism, lies the threat to capitalism. It is what causes men who know that things are going quite wrong to say that things are fundamentally sound."

The US twin deficits in 2005? Thank goodness for the RBA – we hope.

MARTIN EARP
Dec 04