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Book Review

The Forgotten Depression

James Grant
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For as long as every living economist has been plying their trade, a single historical episode has been taken as an *experimentum crucis*. Latin for "crucial experiment", it is what Isaac Newton used to call an observed outcome significant enough, by itself, of determining the validity of a theory. The event serving this function in present-day economics is the Great Depression. And it was John Maynard Keynes and his followers that originally established that as the *experimentum crucis* by arguing that the Great Depression conclusively refuted the classical view that markets are self-correcting and that, therefore, the government has a necessary role to play in countering economic slumps through increased expenditures. Even the critics of the Keynesian school ended up accepting the 1930s as pivotal. Famously illustrating

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this was Milton Friedman with his thesis that blame for the Great Depression ought to be laid at the Federal Reserve for running an overly tight monetary policy. Not just in the U.S., but throughout the developed economies, both these interpretations of the 1930s, traditional Keynesian and monetarist, have come to undergird public policy amidst the various economic stresses that have engulfed the globe since the financial tsunami of 2008. Central banks the world over have resorted to the monetary tap known as quantitative easing. Governments have bolstered their social insurance regimes and poured money into public works.

In his latest book, *The Forgotten Depression*, James Grant proposes that another moment in economic history be treated as an *experimentum crucis*. The former *Barron's* columnist, current editor of an influential financial markets newsletter, and regular media commentator, points us instead to the downturn of 1920–1921. That was the last time, according to Grant, that the U.S. government did not prescribe the now standard cure for economic slumps consisting of fiscal stimulus and easy money. Grant's purpose is to test the efficacy of this medicine by checking what happened when it was not administered. If its absence did not give rise to a prolonged sickness, then one must conclude that state intervention is not required treatment for a fall in economic activity. Indeed, one might then legitimately suspect that the government is worsening matters by hindering forces operating in the market naturally tending towards recovery. This is precisely the conclusion that Grant draws from the 1920–1921 experience—and he reaches it both engagingly and convincingly.

Now anyone looking to use that occasion as an instructive case study is immediately faced with the problem of delineating the extent of the decline. In the early 1920s, the U.S. government had not yet erected a huge statistics collection apparatus with a view to managing the economy. Few doubt the pronouncement of the National Bureau of Economic Research, the authority on business cycles dates, that the decline in economic activity began in January 1920 and subsequently lasted 18 months before bottoming in July 1921 (NBER, 2015). However, gross measures of economic performance, whether GDP or its predecessor GNP, were not calculated at the time. The US Federal Reserve had only recently begun to estimate the nearest equivalent to this, the industrial production index. That fell by 31.5 percent during the 1920–1921 slump. While less devastating than the 51.7 percent drop from 1929–1933 in the throes of the Great Depression, the 1920–1921 period represents the third biggest decrease since the Fed started publishing the statistic in 1919 (Federal Reserve, 2015). Grant is well aware that Christina Romer (1994), as part of her over-all contention that pre-World War II business cycles were both shorter and less volatile than commonly thought, has put forward estimates indicating that the output loss during 1920–1921 was 6.6 percent, short of the 10 percent threshold informally used by economists to classify a given decline in production as a depression. Not being solely absorbed with macroeconomic aggregates, Grant counters this more modest assessment by detailing the various pieces of the economy. He tells us, for example, that automobile production fell by 23 percent, hourly manufacturing wages by 22 percent, and agricultural income by a whopping 56.7 percent, at the same time that the number of bankruptcies tripled with the debt associating with these quintupling. In this way, Grant substantiates that the 1920–1921 downturn was severe enough to offer a revealing empirical trial of the thesis that government is needed to resuscitate a slowing economy.

As with every slowdown in the industrial era, the lead up to 1920–1921 was an unsustainable boom. And as with every such boom, an overabundance of money fueled the ephemeral rise in fortunes. As Grant recounts the story, World War I had just ended when fear of economic collapse gripped observers pointing to the consequences of military production suddenly being wound down. Defying these predictions, consumer demand, long pent-up by the conflict, surged with the return of the soldiers from the European battlefield. To finance the war, however, the Woodrow Wilson administration had enlisted America's newly established central bank to augment the money supply. With the U.S. still nominally on the gold standard, the Fed anticipated that this liquidity injection could be quickly mopped up once hostilities ceased, given that the monetary base was mostly made up of short-term debt instruments that were self-liquidating. But government officials, particularly at the Treasury Department, were in no mood to put the post-war expansion in jeopardy and the Fed, barely five years into its existence, lacked the institutional clout to resist the politicians. Thus, it accommodated the swelling demand, leaving consumers flush with money to spend on goods, which led to a general rise in prices. Not until January 1920 did the Fed summon the will to tighten monetary policy, raising its benchmark interest rate by 1.25 percent to 6 percent. The New York Fed, in a move followed by most other regional branches, then raised it one more time to 7 percent in June 1920.

Several factors combined to preclude any fiscal or monetary response to the ensuing tumble in the economy. Though the White House was occupied by a progressive enthusiast of government activism, Woodrow Wilson was fixated on securing entry of the U.S. into the League of Nations. Cementing what Grant calls an accidental policy of laissez-faire from the executive branch was the stroke that the President suffered in late 1919. In Congress, meanwhile, the dominant factions in both political parties saw the government as having no proper role in steering the economy. When Warren G. Harding subsequently assumed the Presidency in March 1921, both he and his Budget Director, Charles Dawes, brought a more deliberate policy of laissez-faire into the White House, cutting government spending and defeating a campaign in the Senate to offer bonuses to World War I veterans. The economics profession had not yet started advising the political classes to stabilize prices; such arguments were still incubating in the writings of Irving Fisher (1922). Very critical, too, in Grant's telling is that the two most powerful figures within the Fed, W.P.G. Harding, chair of the board, and Benjamin Strong, governor of the New York Fed, both stood against a loosening of monetary policy that would compromise the necessary liquidation of ill-judged investments made during the boom. In this cause, they had to deal with John Skelton Williams, the Comptroller of the Currency, who waged a strident battle for lower interest rates. Such were the emotions that Williams' crusade evoked that W.P.G. Harding once lunged at him during a hearing of the Joint Agricultural Commission.

While this bureaucratic fracas continued, prices fell. Nowadays, such a deflationary outcome is widely viewed with utter horror; it is precisely that which the Great Depression has taught policymakers to avoid at all costs lest the economy go into a downward spiral. Lower prices are thought to be dangerous because investors and consumers are apt to wait until they get lower still, thereby lowering demand for goods and services. This, in turn, is said to cause firms to lay off workers in an effort to cut costs, the resulting increase in unemployment prompting demand to drop further such that prices fall again to reinforce the caution among investors and consumers. On the contrary, Grant observes that prices did not keep plummeting into infinite depths, but eventually found a base once consumers saw there were good deals to be had in the stores and investors spotted the prospect of higher returns on capital projects thanks to lower costs for wages and materials. Left alone, the price system worked to restore the economy back to health by mid-1921. The foundations were thus set for a robust expansion that marked the rest of the decade in the U.S., an era that made for a telling contrast to the economic stagnation that went on to plague Britain, where prices, especially that for labor, had become sticky with the rise of unionism. As Grant encapsulates his account of 1920–1921: "the hero of my narrative is the price mechanism, Adam Smith's invisible hand" (p. 2).

For those who rather put their faith in the visible hand of the state, two lines of attack are open against Grant. One of them is to reject the causal framework of his story. This argument holds that market forces were actually not allowed free sway, that the government was a significant player, and that its central bank arm both caused and ended the 1920–1921 downturn, first by tightening monetary policy in 1920 and then by easing in 1921 (Economist, 2014). Yet Grant does not deny that the government instigated the slump. It did so, however, by fomenting the prior boom with artificially low interest rates. Unfortunately, he puts less emphasis on the malinvestments than he does on the inflationary dynamic this policy created, but Grant is right to insist that the Fed cannot be faulted for tightening monetary conditions in the face of escalating prices. Such a move, after all, is part of the currently accepted playbook for monetary policy. It does become thornier to disentangle cause from effect with respect to the ending of the 1920–1921 downturn, inasmuch as the New York Fed began to lower its benchmark rate in May 1921, two months before the economy hit bottom. Admittedly, this is an intriguing coincidence, but it is universally acknowledged that monetary policy involves a lag between its implementation and its impact on the economy. This lag is typically estimated to be around a year, not two months.

With respect to the second line of possible attack, Grant is more vulnerable. At a conference not too long ago, I recall a central banker urging a version of this by first conceding that the market can be relied upon to cure itself of a slowdown through a downward adjustment in prices. But, he added, there is inevitably going to be much suffering along the way; many will be forced into unemployment. Better, he said, for the central bank to intervene with monetary stimulus so as to smooth the necessary adjustment in the economy while minimizing the blow on people's livelihoods. In other words, doing nothing is cruel. Grant provides fodder for this charge by observing that the unemployment rate, though no one can be sure exactly how much it increased, reached double digit levels at the nadir of the 1920–1921 decline.

His answer to the cruelty charge, though, is that any attempt to cushion the required correction in the economy will only serve to prolong the malaise. He points out that is what happened with both Herbert Hoover's efforts to avert a decline in wages at the onset of the Great Depression as well as the larger economic rescue operation launched by Franklin D. Roosevelt's New Deal. Grant calls our attention as well to the anemic recovery that has followed the trio of deficit spending, zero interest rates, and quantitative easing adopted to combat the Great Recession of 2008–2009. Still, this is to suggest a trade-off between the duration of pain and its magnitude. When the business cycle turns negative, it seems, we must either choose between a quick, but more painful resolution to the imbalances generated by the preceding boom or a lengthier but less painful experience. If that is the case, then Grant needs to demonstrate why the first option is superior, which would necessarily entail grappling with the sorts of value judgments that are the province of moral and political philosophy. If that trade-off is more apparent than real, then he has to show that the state's endeavor to ameliorate the pain of a downturn will not just delay the recovery, but ultimately come to nothing.

No incident from the economic past can really be treated as an *experimentum crucis*. When it comes to human affairs, any particular sequence of events one happens to isolate will inevitably embody a unique configuration that renders it impossible to draw lessons applicable to every other analogous circumstance. An economic theory can only be as empirically good as the range of historical situations it can explain. While highly illuminating, 1920–1921 cannot serve as the final word in the contest between the laissez-faire and interventionist approaches to the fluctuations of economic life. But neither can the 1930s as conventionally understood. In this enlarging of historical perspective lies the chief benefit of Grant's book.

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